Related party transactions – Audit Issues

The Questions and Answers (Q&As) below are developed by the Working Group on Mainland Audit Issues of the Institute's Auditing and Assurance Standards Committee (AASC) to raise practising members' awareness of the common audit issues that may be encountered by auditors in the audits of the financial statements of Mainland enterprises that are prepared under the Hong Kong Financial Reporting Standards (HKFRS) framework. This is particularly important for audits of Mainland enterprises because of the uniqueness and complexity of the structures of these enterprises. They should be read in the light of the following documents and other Hong Kong Standards on Auditing issued by the Institute:

1. Hong Kong Accounting Standard 24 "Related Party Disclosures" (HKAS 24)

Practising members are recommended to familiarize themselves with the definition of related party in HKAS 24 and are to note that the exemption from disclosure of related party transactions by state-owned enterprises in the Mainland has been lifted in HKSA 24.

2. Hong Kong Standard on Auditing 550 "Related Parties" (HKSA 550)

HKSA 550 establishes standards and provides guidance on the auditor's responsibilities and audit procedures regarding related parties and transactions with such parties.

In this regard, practising members are to note that given the involvement of related parties, such as directors, owners, and management, in major corporate scandals around the world, the International Auditing and Assurance Standards Board (IAASB) of the International Federation of Accountants (IFAC) intends to revise the extant ISA 550 on which HKSA 550 is based. The proposed revision to ISA 550 was recently published and the Institute is seeking comments on the IAASB Exposure Draft which has been posted on the Institute's website at: http://www.hkicpa.org.hk/professionaltechnical/assurance/exposuredraft/ed_IAASB_ISA550.pdf, for comment by 10 April 2006.

The proposed revised standard seeks to extend current practice by requiring practising members to obtain an understanding of the nature and business rationale of an entity's related party relationships and transactions sufficient to identify, assess and respond to the risks of material misstatement resulting from them. It also places greater emphasis on the difficult task for practising members of attempting to identify related party relationships and transactions not identified or disclosed by management.

3. Hong Kong Standard on Auditing 240 "The Auditor's Responsibilities to Consider Fraud in an Audit of Financial Statements" (HKSA 240)

Practising members are to note that significant related-party transactions not in the ordinary course of business, or with related entities not audited or by another firm, have been specifically identified in Appendix 1 of HKSA 240 as opportunities of examples of Fraud Risk Factors.

Given the complexity of ownership of some of the shareholding structures of Mainland enterprises, practising members are recommended to exercise greater caution where carrying out audit procedures on related parties.

This set of Q&As addresses some of the common issues relating to auditing related party transactions in Mainland enterprises, including some background information about related party transactions, the common questions to be considered in the planning process and the practical procedures that can be applied to ascertain the completeness of related party disclosures.

The Working Group welcomes your comments and feedback, which should be sent to commentletters@hkicpa.org.hk, for the attention of Patricia McBride, Director, Standard Setting.

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Q1: What are the potential risks relating to the audit of related party transactions ("RPTs") and what are the practical examples of RPTs?

A1: RPTs have always been a crucial audit area which we need to pay particular attention to during the course of an audit. Due to the nature of RPTs, the pricing policies, manner of settlement and other terms of the transactions of RPTs may be different from those with independent third parties. The RPTs may not be on an arm's length basis and can be more favourable or less favourable depending on each situation. For instance, if an enterprise intends to shift some of its profits from a high tax regime to a lower one, it may be inclined to set up a transfer pricing strategy to sell goods to a related party at a lower-than-market price. In this case, the profits of the enterprise may be affected and there may be potential transfer pricing tax exposure. In addition, there may be a risk of financial statements manipulation if certain profits/losses/assets/liabilities are shifted out from an enterprise by way of arranging RPTs. The potential audit risk is even heightened if the related parties are not audited by the same auditor.

Failure to identify and appropriately disclose significant RPTs may lead to material misstatement of the financial statements and hinder the financial statements from giving a true and fair view of the state of affairs of the entity and of the results of its operation.

Transactions (e.g. sales, purchases or advances) with companies controlled by the directors, associated companies, joint ventures, the enterprise's key management personnel and major shareholders are some examples of RPTs.

Q2: What are the common difficulties in auditing RPTs of Mainland enterprises?

A2: Some of the common difficulties are as follows:

a. <u>Inadequate knowledge about the definition of RPTs</u>

Owning to the fast growing economy, most enterprises operating in Mainland China have experienced tremendous growth in business operation while the organisation structures cannot catch up with the pace of the growth. In general, their personnel are not familiar with the definition of RPTs under HKFRS and thus they are not able to properly identify RPTs. For instance, a transaction between an enterprise and a company, over which any key management personnel is able to exercise control or significant influence, is easily missed out when identifying RPTs.

b. <u>Lack of sound internal control system</u>

There may be incomplete RPTs identification due to inadequate internal control system with respect to the recording and reporting of RPTs. Accordingly, major RPTs originated in each business unit may not be adequately reported back to the head office.

Q3: How to identify RPTs?

A3: Identification of RPTs is a vital audit process and some of the common steps that could be used are as follows:

- request from appropriate management personnel for a list of names of all known related parties and any transactions with those parties during the period;
- review the minutes of meetings of stockholders, the board of directors and other meetings for material transactions authorized or disclosed;
- understand and evaluate investment transactions, for example, purchase or sale of an equity interest in a joint venture or other entity;
- review confirmations of loan receivable and payable for indications of guarantees and determine the relationships, if any, of the guarantors to the reporting enterprise;
- examine accounting records for material, unusual or nonrecurring transactions or balances (for example, loans to officers, directors, associated companies and individual parties), with special attention to transactions recognized at or near the end of the period; and
- check background of parties which have material or unusual transactions with the enterprise by performing company search or site visit.

Q4: What are the practical procedures that an auditor can apply to evaluate the completeness of RPTs?

A4: The following procedures could be applied and performed:

- review prior-year working papers for names of known related parties;
- ask predecessor, principal or other auditors of related entities about existing relationships and the extent of management involvement in material transactions;
- inquire as to the affiliation of directors and officers with other entities;
- obtain and review a listing of principal shareholders from the share register;
- scrutinize filings with, and other information supplied to, the relevant authorities/regulatory agencies (including income tax returns) and other appropriate sources for the names of related parties and for other businesses in which officers and directors have ownership interests or occupy directorship or management positions;
- examine correspondence and invoices from law firms;
- perform company search and site visits; and
- review the extent and nature of business transacted with major customers, suppliers, borrowers and lenders.

Q5: What are the common procedures that an auditor can perform in auditing RPTs?

A5: Some of the common procedures are:

a. <u>Understand and evaluate the enterprise's procedures for identifying, authorising and accounting for RPTs</u>

   - scrutinize the formal policies and evaluate the dissemination of the policies as applicable to officers, employees, vendors and customers;
   - assess the internal control system regarding the recording and reporting of RPTs and the methodology for monitoring adherence with policies; and
   - review the policy statements regarding corporate ethics and conflicts of interests and if available inspect statements of compliance with business ethics and conflicts of interest policies received from officers, directors and key employees.

b. <u>Obtain sufficient audit evidence to gain comfort on material RPTs</u>

   - obtain an understanding of how management gains comfort that RPTs have been properly recorded and disclosed, and evaluating this;

- obtain an understanding of the business purpose of the transaction and determine the methods of establishing terms of transactions and consider the effect of transactions (e.g. transfer pricing) with related parties;

- obtain information on the financial capabilities of the related parties which would bear upon the parties' ability to meet their obligations;

- scrutinize invoices, executed copies of agreements, contracts and other pertinent documents and assess the transactions have been approved at the appropriate level of management or by the board of directors;

- circularise confirmations on significant aspects of transactions and balances, including the nature of the relationship, the terms and amount of the transaction, guarantees the terms and manner of settlement of outstanding balances, etc.; and

- discuss significant information, as appropriate, with intermediaries such as banks, guarantors, agents or lawyers to obtain a better understanding of the transaction.

c. <u>Verify the correctness of information for disclosure items</u>

- the nature of the relationships;

- the amounts due from or to related parties and the terms and manner of settlement;

- a description of the transactions (summarized, when appropriate) for the period reported on, including amounts and such other information for an understanding of the effects on the financial statements; and

- the amount of the transactions and the effects of any change in the method of establishing terms from that used in the preceding period.