

## SA 550 Related Parties

### Scope

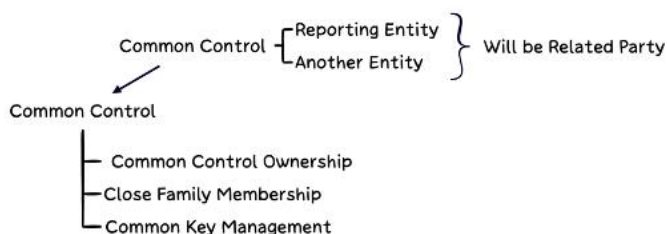
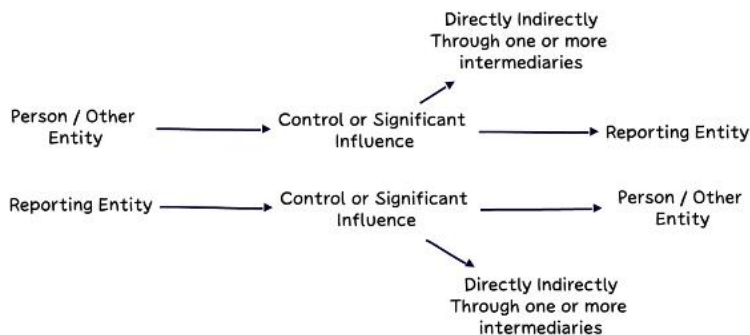
This SA addresses the auditor's responsibilities for related party relationships and transactions, expanding on SA 315, SA 330, and SA 240 regarding related risks of material misstatement.

### Definition of Related Party

A party that is either

- i. A related party as **defined** in the applicable financial reporting framework; or
- ii. Where the applicable financial reporting framework establishes minimal or no related party requirements:
  - a) A **person** or **other** entity that has **control** or **significant influence**, directly or indirectly through one or more intermediaries, over the reporting entity;
  - b) **Another entity** over which the reporting entity has **control** or **significant influence**, directly or indirectly through one or more intermediaries; or
  - c) Another entity that is under **common control** with the reporting entity through having:
    - i) Common controlling ownership;
    - ii) Owners who are close family members; or
    - iii) Common key management.

However, entities that are under common control by a state (i.e., a national, regional or local government) are not considered related unless they engage in significant transactions or share resources to a significant extent with one another



### Meaning of control and significant influence in reference to related party

- Many financial reporting frameworks discuss the concepts of control and significant influence. They generally explain that:

- i. Control is the **power to govern** the **financial and operating policies** of an entity so as to obtain benefits from its activities; and
  - ii. Significant influence (which may be gained by share ownership, statute or agreement) is the **power to participate** in the **financial and operating policy decisions** of an entity, but is not control over those policies.
- The existence of the following relationships may indicate the presence of control or significant influence:
    - i. Direct or indirect equity holdings or other financial interests in the entity.
    - ii. The entity's holdings of direct or indirect equity or other financial interests in other entities.
    - iii. Being part of TCWG or key management (i.e., those members of management who have the authority and responsibility for planning, directing and controlling the activities of the entity).
    - iv. Being a close family member of any person referred to in subparagraph (iii).
    - v. Having a significant business relationship with any person referred to in subparagraph (iii).

**What do you mean by control and significant influence? Give some examples of the relationship, the existence of which indicate control and significant influence.**

### Meaning of Related Parties with Dominant Influence

Related parties, by virtue of their 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 behaviour is relevant when identifying and assessing the risks of material misstatement due to fraud.

**Example:** If a major shareholder (who is a related party) pressures the company to manipulate financial statements to show higher profits, this is dominant influence.

**Why is it Important for the Auditor?**

Such influence may increase the risk of fraud or manipulation, especially if the related party wants to achieve personal gain.

### Meaning of Special-Purpose Entities as Related Parties

In some circumstances, a special-purpose entity may be a related party of the entity because the entity may in substance control it, even if the entity owns little or none of the special-purpose entity's equity.

**Mr. Mehta runs a company called Mehta Constructions Ltd.**

**He wants to borrow ₹100 crores to build a new township, but he doesn't want this big loan to appear on his company's balance sheet – it might scare investors.**

**So, he sets up a new company called Urban Build SPV Pvt. Ltd. – a special-purpose entity (SPE).**

**He tells a few friends to become shareholders of this new SPE so that Mehta Constructions officially owns only 1% of it.**

On paper, it looks like Mehta Constructions has nothing to do with Urban Build SPV.

But in reality:

All major decisions of the SPE are taken by Mr. Mehta.

The project is planned, executed, and funded by Mehta Constructions.

All profits or losses ultimately affect Mr. Mehta's business.

So even though Mehta Constructions is not the legal owner of the SPE, it controls it "in substance," and therefore SPE is a related party

### Nature of Related Party Relationships and Transactions

- Many related party transactions in the normal course of business may not carry higher misstatement risk than those with unrelated parties.
- However, related party relationships and transactions may sometimes pose higher misstatement risk than those with unrelated parties.
- For example,
  - Related parties may use **complex relationships** and **structures**, increasing the complexity of their transactions.
  - **Information systems** may be **ineffective** at identifying or summarising 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.

Many related party transactions are in the normal course of business. 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. Give a few examples of such areas. (ICAI Study Material – Test Your Knowledge)

### Understanding the Entity's RPRT

The auditor **shall inquire of management** regarding:

- The **identity** of the entity's related parties, including **changes** from the prior period;
- The **nature** of the relationships between the entity and these related parties; and
- Whether the entity entered into any **transactions** with these related parties during the period and, if so, the **type** and **purpose** of the transactions.
- The auditor shall **inquire** of management and others within the entity, and perform **other risk assessment procedures** considered appropriate, to obtain an **understanding** of the **controls** if any in that management has established to
  - **Identify, account** for, and **disclose** related party relationships and transactions in accordance with the applicable financial reporting framework.

- **Authorise** and **approve** significant transactions and arrangements with related parties; and
- **Authorise** and **approve** significant transactions and arrangements outside the normal course of business.

### Considerations specific to smaller entities by the auditor

- Control environment in smaller entities may differ as TCWG might not include outsiders, and governance may be handled by the owner-manager.
- Control activities in smaller entities may be less formal with no documented processes for related party relationships and transactions.
- An owner-manager may reduce or increase risks from related party transactions through active involvement in all key aspects.
- For such entities, the auditor understands related party transactions and controls via management inquiry, oversight observation, and document inspection.

### Records or documents that may provide information about related party relationships and transactions

During audit, auditor should stay alert for related party info while reviewing records, and may inspect documents revealing related party relationships and transactions, e.g.

1. Entity **Income tax returns**.
2. **Information** supplied by the entity to **regulatory authorities**.
3. **Documents** associated with the entity's filings with a **securities regulator** e.g. prospectuses)
4. **Statements** of conflicts of interest from management and TCWG.
5. **Contracts** and **agreements** with key management or TCWG.
6. Significant **contracts** and **agreements** not in the entity's ordinary course of business.
7. Significant **contracts re-negotiated** by the entity during the period.
8. Specific **invoices** and correspondence from the entity's professional advisors.
9. **Internal auditors' reports**.
10. **Shareholder registers** to identify the entity's principal shareholders.
11. **Life insurance policies** acquired by the entity.
12. **Records** of the entity's investments and those of its pension plans.

While performing audit of financial statements of a listed company, statutory auditor needs to maintain an attitude of professional skepticism for related party information. State examples of the records or the documents that may provide information about related party relationships and transactions. (MTP1, Sep 2024, 5 Marks)