RELATED PARTIES AND FINANCIAL STATEMENTS: WHO, WHAT AND WHY

HIGHLIGHTS OF TECHNICAL CLINIC

Related parties (RPs) are not independent of each other and therefore users of the financial statements are generally interested to understand the relationship between RPs and the potential financial impact of the transactions entered into with RPs on the financial statements.

With the growing complexity of corporate structures and operations, there is also an increasing need for the auditors to increase their focus on the potential for material misstatements, particularly due to fraud, arising from relationships and transactions with RPs. Luar Eng Hwa, Partner of

EH Luar & Co and Alliance Practice LLP, shared insights on this topic with a group of practitioners. The main points are highlighted below.

Q1 Why is there so much emphasis on the audit of RPs?

Many high profile accounting frauds in recent years revealed that fraudulent reporting often involves RPs. This creates concern among regulators and users of the financial statements about the proper monitoring, accounting and auditing of such transactions. An infamous case of such fraud is Enron, where RPs played a significant role in the company's fraudulent financial reporting. According to a study conducted by the University of Miami on The Role of RPTs in Fraudulent Financial Reporting, "the company fraudulently manufactured earnings and concealed debt and losses by variously: manipulating asset values, entering into sham transactions through and with related entities, reorganising segments to conceal loss-making entities within profitable segments, manipulating expenses and creating and using special reserves. In addition, the Chief Financial Officer earned over US$30 million from undisclosed investments in the company's special purpose entities". Hence, there is a need to emphasise that it is necessary for the auditors to be aware of RPs and their effect on the financial statements.

As RPs are not independent of the entity, the pricing policies, manner of settlement and other terms of the RP transactions (RPTs) may be different from those with independent third parties. Such transactions may not be at arm's length and can be more or less favourable depending on each situation. This information is relevant to a financial statement user who is assessing the entity's operation.

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SSA 550(R) PARA 15 SPECIFICALLY REQUIRES THE AUDITORS TO INSPECT BANK AND LEGAL CONFIRMATIONS OBTAINED AS PART OF THE AUDITORS' PROCEDURES AND INSPECT MINUTES OF MEETING OF SHAREHOLDERS AND THOSE CHARGED WITH GOVERNANCE FOR INDICATIONS OF THE EXISTENCE OF RELATIONSHIPS WITH RPS OR RPTS THAT MANAGEMENT HAS NOT PREVIOUSLY IDENTIFIED OR DISCLOSED TO THE AUDITORS.

Q2 Who is responsible for identifying RPs and RPTs? What are the common audit procedures the auditors can perform to identify and evaluate the completeness of RPs and RPTs?

The management is responsible for providing the auditors with a complete and accurate list of RPs and RPTs and the auditor's duty is to audit the information provided by the management. Singapore Standard on Auditing (SSA) 550(R) para 15 specifically requires the auditors to inspect bank and legal confirmations obtained as part of the auditors' procedures and inspect minutes of meeting of shareholders and those charged with governance (TCWG) for indications of the existence of relationships with RPs or RPTs that management has not previously identified or disclosed to the auditors.

Some other common audit procedures the auditors can perform to identify and evaluate the completeness of RPs and RPTs include:

- Engage with appropriate key management personnel to understand management's internal procedures for identifying and accounting for RPTs
- Review prior years' audit documentation for names of known RPs
- Ask predecessor or other auditors of related companies about existing relationship and the extent of management involvement in material transactions
- Inquire appropriate management personnel as to the affiliation of

TCWG with other companies

- Review the nature and extent of business transacted with major customers, suppliers, borrowers and lenders for any unusual or preferential terms for indication of RPTs
- Purchase the business profile of the company from the Accounting and Corporate Regulatory Authority's website for information on the names of the directors and shareholders to identify RPs
- Obtain the group structure for a subsidiary of a group to identify names of RPs

The auditors should also obtain a written representation from management confirming the identity of the company's RPs, the relationships and transactions of which they are aware.

Q3 What should the auditors do in the event that they have identified previously unidentified or undisclosed RPs or RPTs?

The auditors should seek to understand from the management and evaluate the underlying circumstances of such transactions, and why such transactions were not identified previously. Auditors should then request the management to identify all such transactions for the auditors' further evaluation.

The auditors are then required to communicate to the engagement team such information for them to consider the implication to the audit and the need to reassess the risk of material misstatements to the overall financial statements.

When deciding on the types and extent of audit procedures on the newly-identified RPs, auditors need to consider management's response and the auditors' reassessed risk. If the non-disclosure by management appears intentional and therefore indicative of a risk of material misstatement due to fraud at the assertion level, the auditors shall design and perform further audit procedures whose nature, timing and extent are responsive to the now significantly higher assessed risks of material misstatement at that assertion level. Further guidance is set out in SSA 240(R).

Q4 Should the auditors regard significant identified RPTs outside the normal course of business as a significant risk?

SSA 550 para 18 specifically requires the auditors to treat significant identified RPTs outside the entity's normal course of business as giving rise to significant risks. The auditors need to understand and evaluate management's business rationale for having such transactions, that is, through inquiry of management and review of correspondences, signed contracts or agreements. Having obtained the understanding, the auditors should check that the transactions are appropriately authorised, approved, accounted for and disclosed in the financial statements.

Examples of such transactions include:

- Complex equity transactions, such as corporate restructuring or acquisition
- Transactions with offshore entities in jurisdictions with weak corporate laws
- 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

Q5 Are the auditors required to perform audit procedures to determine whether the transactions entered into with the RPs are at arm's length?

SSA 550 para 24 specifically states that if management has made an assertion in the financial statements to the effect that RPTs are conducted on terms equivalent to those prevailing for arm's length transactions, the auditors shall obtain sufficient appropriate audit evidence about the assertion.

The preparation of the financial statements is the responsibility of the management. Where such assertion is made in the financial statements, the management is required to substantiate the assertion by providing support. Such support may include:

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

The auditors are required to evaluate the management's support by verifying to the source of the internal or external data supporting the assertion, and testing the data to determine their accuracy, completeness and relevance and where applicable, consider the appropriateness of management's process for supporting the assertion and evaluate the reasonableness of any significant assumptions on which the assertion is based. In practice, most of the supporting documents can be verified in the course of the auditor's work.

Q6 It is a common practice that auditors simply obtain confirmations from the RPs for the balances outstanding and the RPTs transacted for the financial period without performing further audit procedures to verify the transactions. Is that adequate work done?

The confirmation received from RPs addresses the completeness and accuracy of balances outstanding and transactions with RPs for the financial period. However the confirmation on its own is insufficient evidence that such transactions and balances have been correctly recorded. The auditors would also need to satisfy themselves as to the validity of the purpose, nature and extent of these transactions and balances and their effect on the financial statements.

In the process of obtaining and confirming an understanding of the business purpose of such transactions, the auditors may examine invoices, executed copies of agreements, contracts, or other pertinent documents, for example, shipping documents, and determine whether the transactions have been approved by the board of directors or other appropriate management personnel. Where the auditors assessed that the transactions appear unusual and the full effect of the transactions may not be properly accounted for or disclosed in the financial statements, additional procedures may be necessary. The Public Company Accounting Oversight Board AU Section 334 sets out examples of such procedures:

- Confirm transaction terms including guarantees and other significant data, with the other party or parties to the transaction
- Inspect evidence in possession of the other party or parties to the transaction
- Confirm or discuss significant information with intermediaries, such as banks, guarantors, agents, attorneys, to obtain a better understanding of the transaction
- Refer to financial publications, trade journals, credit agencies, and other information sources when there is reason to believe that unfamiliar customers, suppliers, or other business enterprises with which material amounts of business that have been transacted lack substance
- With respect to material uncollected balances, guarantees, and other obligations, obtain information about the financial capability of the other party or parties to the transaction. Such information may be obtained from audited/unaudited financial statements or credit agencies. The auditors should decide on the degree of assurance required and the extent to which available information provides such assurance.

THE MANAGEMENT IS RESPONSIBLE FOR PROVIDING THE AUDITORS WITH A COMPLETE AND ACCURATE LIST OF RPS AND RPTS AND THE AUDITOR'S DUTY IS TO AUDIT THE INFORMATION PROVIDED BY THE MANAGEMENT.

Q7 If the management's records are incomplete or not in proper order such that the auditors' ability to perform the required audit procedures are hampered, what can be done?

The auditors have to consider the extent of scope limitation and whether alternative audit procedures could be performed. For smaller companies with a simple structure and small management team, the risk of RPs and/or RPTs not being identified is unlikely to be as high as bigger companies with a complex group structure. RPTs in smaller companies are usually routine and straightforward, therefore the auditors should still be able to perform audit procedures to check that the companies have properly and completely identified the RPTs and appropriately disclosed them in the financial statements.

If the auditors, after performing further audit procedures, are still of the view that there is insufficient appropriate audit evidence concerning RPs and RPTs, or conclude that the management's disclosure in the financial statements is not adequate, qualification is likely to be inevitable. In this scenario, the auditors will need to communicate with TCWG on the potential qualification and the circumstances that lead to the qualification of audit opinion.

Any modified opinion should not be taken lightly. Consequently, the auditors should find out whether the company will make improvements to their accounting and financial reporting function to address incomplete and improper record-keeping and if not, they should consider whether it is worth keeping the client. CPA

By Magdalene Ang, Quality Assurance Manager, ICPAS