

Auditing Standard

AUS 518
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Related Parties

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Auditing Standards contain the basic principles and essential procedures identified in bold-type (black lettering) which are mandatory, together with related guidance. For further information about the responsibility of members for compliance with AUSs refer Miscellaneous Professional Statement APS 1.1 "Conformity with Auditing Standards".

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AUDITING STANDARD
AUS 518 “RELATED PARTIES”

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MAIN FEATURES OF THE STANDARD

The Standard:

- (a) Establishes standards and provides guidance for auditors on the risk of material misstatements in the financial report resulting from the existence of related parties and related party transactions, when planning and performing audit procedures and when evaluating and reporting the results of such procedures.
- (b) Requires that auditors assess the risk that related parties and related party transactions will not be identified, or appropriately disclosed and/or measured.
- (c) Requires that auditors be alert for unusual transactions which may indicate the existence of previously unidentified related parties or related party transactions.
- (d) Identifies audit reporting considerations in relation to related parties and related party transactions.

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Introduction

- .01 The purpose of this Auditing Standard (AUS) is to establish standards and provide guidance on the auditor’s responsibilities and audit procedures regarding related parties and transactions with such parties.
- .02 ***When planning and performing audit procedures and in evaluating and reporting the results thereof the auditor should consider the risk of material misstatements in the financial report resulting from the existence of related parties and related party transactions.***
- .03 Definitions regarding related parties are given in Accounting Standard AASB 1017 “Related Party Disclosures” and Australian Accounting Standard AAS 22 “Related Party Disclosures”, and are adopted for the purpose of this AUS.
- .04 Management is responsible for the identification and disclosure of related parties and transactions with such parties. An adequate internal control structure will help management to ensure that transactions with related parties are appropriately identified in the accounting records and disclosed in the financial report.
- .05 The auditor has a level of knowledge of the entity’s business and the industry that will enable the identification of events, transactions and practices that may have a material effect on the financial report. While the existence of related party relationships and transactions between related parties are considered ordinary features of business, the auditor needs to be aware of them because:
- (a) the financial reporting framework for general purpose financial reports requires disclosure of, as a minimum, those related party relationships and transactions identified by AASB 1017/AAS 22;
 - (b) the existence of related parties or related party transactions may affect the financial report. For example, provisions relating to financial benefits to related parties under the *Corporations Act 2001*, or where the entity’s tax liability and expense may be affected by tax laws which require special consideration when related parties exist;
 - (c) the source of audit evidence affects the auditor’s assessment of its reliability. A greater degree of reliance may be placed on audit evidence obtained from or created by unrelated third parties;

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- (d) a related party transaction may be motivated by other than ordinary business considerations, for example, inappropriate profit sharing or fraud; and
 - (e) the potential for error may increase because documentation regarding related party transactions may receive less scrutiny than documentation regarding other transactions.
- .06 Related parties and related party transactions can be difficult to identify and measure because:
- (a) related parties may operate through an extensive and complex range of relationships and structures;
 - (b) related party transactions may not always involve an exchange of consideration;
 - (c) transactions with related parties may not be at arm’s length and may be controlled, manipulated and/or concealed by management.
- .07 ***When performing audit procedures which may identify related parties and related party transactions, the auditor should consider the substance of the relationship and/or transaction being tested and not merely the legal form.*** In considering substance over legal form, the auditor considers the guidance in Australian Accounting Standard AAS 6 “Accounting Policies”, Accounting Standard AASB 1001 “Accounting Policies” and Statement of Accounting Concepts SAC 3 “Qualitative Characteristics of Financial Information”.

Assessing Risk

- .08 ***Based on the auditor’s knowledge of the business and enquiries of management, the auditor should assess the risk that related parties and related party transactions will not be identified, or that related party transactions will not be disclosed or measured in accordance with the relevant financial reporting framework.***

Inherent Risk

- .09 To assess inherent risk, the auditor uses professional judgement to evaluate the relevant factors. The following factors affect the inherent risk assessment in relation to related parties:
- (a) a complex organisational or ownership structure may make the identification of related parties more difficult, a

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situation which may be further complicated when the auditor does not audit all entities within an economic entity;

- (b) the number of related parties and the volume of related party transactions;
- (c) the extent to which the entity operates in foreign jurisdictions;
- (d) goods or services are provided at no charge;
- (e) indications of changes in the terms of transactions with related parties, particularly if they no longer reflect normal commercial terms;
- (f) the entity is experiencing difficulty meeting the terms of debt agreements or has going concern problems;
- (g) the entity has aggressive incentive programmes or is experiencing rapid growth in profitability when compared with other entities in the same industry;
- (h) the nature of transactions with related parties, such as those involving intangibles.

Control Risk

.10 Based on the auditor’s understanding of the entity’s internal control structure, the auditor makes a preliminary assessment of control risk as it relates to the identification of related parties and the authorisation and recording of related party transactions. This assessment involves consideration of policies and procedures relating to matters such as:

- (a) ensuring that declarations of interests in other entities are current and communicated by and to appropriate levels within the entity;
- (b) identifying related party transactions within accounting systems, including those policies and procedures which ensure the recording of transactions for which no consideration has been received or paid; and
- (c) authorising and approving prices for transactions with related parties, including those not in the normal course of operations.

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- .11 In some circumstances, the entity’s control procedures may not be effective in providing relevant and reliable information about related parties and related party transactions, particularly those that are not in the normal course of operations. In this case control risk is assessed as high.
- .12 In other circumstances, however, the auditor may assess control risk at less than high and performs tests of controls to support that assessment.

Substantive Procedures

- .13 ***The auditor should consider the assessed levels of inherent and control risks in determining the nature, timing and extent of substantive procedures.*** The higher the assessment of inherent and control risks, the more audit evidence that needs to be obtained from the performance of substantive procedures to reduce risk to an acceptable level.
- .14 The auditor reviews information provided by management about the existence of related parties and related party transactions.
- .15 The names of identified related parties are 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.
- .16 Audit procedures directed to reducing the risk of related parties remaining undetected to an acceptably low level include:
 - (a) reviewing prior period working papers for names of known related parties;
 - (b) inquiring of management and obtain management representation regarding the names of all known related parties;
 - (c) inquiring as to the affiliation of management (including members of the governing body) with other entities;
 - (d) reviewing shareholder records to determine the names of principal shareholders or, if appropriate, obtain a listing of principal shareholders from the share register;
 - (e) reviewing minutes of meetings of shareholders, the governing body and other important committees, and other

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relevant statutory records such as the register of directors’ interests;

- (f) inquiring of other auditors currently involved in the audit, or predecessor auditors, as to their knowledge of additional related parties;
- (g) reviewing the entity’s income tax returns and other information supplied to regulatory agencies;
- (h) inquiring as to the names of all pension and other trusts established for the benefit of employees, and the names of their management and trustees;
- (i) reviewing invoices and correspondence from lawyers for indications of the existence of related parties; and
- (j) reviewing contracts and agreements, for example management agreements and trust agreements.

Circumstances Encountered During the Audit

- .17 ***During the course of the audit, the auditor should be alert for transactions which appear unusual in the circumstances and may indicate the existence of previously unidentified related parties or related party transactions.***
- .18 The following are examples of transactions which may indicate the existence of unidentified related parties:
 - (a) transactions which have abnormal terms of trade, such as unusual prices, interest rates, guarantees or repayment terms;
 - (b) transactions which appear to lack a logical or business reason for occurrence;
 - (c) transactions in which substance differs from form;
 - (d) transactions processed or approved in an unusual or non-routine manner or by personnel who do not ordinarily deal with such transactions;
 - (e) high volume or significant transactions with certain customers or suppliers as compared to others; and

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- (f) unrecorded transactions such as the receipt or provision of management services at no charge.
- .19 During the course of the audit, the auditor carries out audit procedures which are directed to other audit objectives, but 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, the governing body and important committees;
 - (c) reviewing accounting records for large or unusual transactions or balances, paying particular attention to transactions recorded 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; and
 - (e) reviewing investment transactions, for example purchase or sale of an equity interest in a joint venture or other entity.
- .20 If, given the circumstances identified in paragraphs .18 and .19, the auditor has reason to suspect the existence of previously unidentified related party transactions, then the auditor performs further audit procedures which are specifically designed to determine whether related party transactions have occurred.
- .21 Where during the audit, the auditor identifies related parties or related party transactions not previously identified, the auditor considers the reason for this, and the need to reassess inherent and control risk concerning the identification of related parties and related party transactions. When there is a reassessment of these risks, the auditor considers the impact on other aspects of the audit.

Examining Identified Related Party Transactions

- .22 *In examining the identified related party transactions, the auditor should obtain sufficient appropriate audit evidence as to whether these transactions have been properly recorded and disclosed.*
- .23 Given the nature of related party relationships, evidence of a related party transaction may be limited, for example regarding the

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existence of inventory held by a related party on consignment or an instruction from a parent entity to a subsidiary to record a royalty expense. Because of the limited availability of appropriate evidence about such a transaction, the auditor considers performing audit procedures such as:

- (a) discussing the purpose of the transaction with management;
- (b) confirming the terms and amount of the transaction with the related party or with the related party’s auditor;
- (c) inspecting evidence in possession of the related party; and
- (d) confirming or discussing information with persons associated with the transaction, such as banks, solicitors, guarantors and agents.

Management Representations

- .24 The auditor ordinarily obtains a specific written representation from management concerning the completeness and adequacy of related party disclosures in the financial report to corroborate any other audit evidence obtained.

Materiality

- .25 When determining materiality regarding related parties, the auditor considers 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) the 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 report; and
 - (c) director related disclosures are deemed material regardless of the quantum of the amounts involved.
- .26 The auditor may consider it appropriate to request management to estimate or place an imputed value on transactions in order to determine the impact on the financial report, for example transactions that have occurred but which have no recorded value.

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Audit Conclusions and Reporting

- .27 *If the auditor is unable to:*
- (a) *obtain sufficient appropriate audit evidence regarding related parties and related party transactions; or*
 - (b) *form a conclusion as to the completeness of the disclosure of related party relationships and transactions,*
- the auditor should, in accordance with AUS 702 “The Audit Report on a General Purpose Financial Report”, express an “except for” opinion or an inability to form an opinion on the basis of a limitation on the scope of the audit.*
- .28 *If the auditor concludes that the related party disclosures in the financial report:*
- (a) *do not satisfy the requirements of the relevant accounting standard; or*
 - (b) *are otherwise inadequate,*
- the auditor should, in accordance with AUS 702 “The Audit Report on a General Purpose Financial Report”, express an “except for” opinion or an adverse opinion. The audit report includes the information that would have been included in the financial report had the relevant accounting standard been followed.*

Operative Date

- .29 This AUS, which incorporates amendments made by AUS/AGS Omnibus 3 “Miscellaneous Amendments to AUSs and AGSs”, is operative from July 2002. This version of AUS 518 supersedes AUS 518 “Related Parties”, as revised in February 2000.

Compatibility with International Standards on Auditing

- .30 There are a number of differences between this AUS and International Standard on Auditing ISA 550 “Related Parties”:
- (a) in the absence of unusual circumstances and any indication of a material misstatement, ISA 550 permits the auditor to limit audit procedures regarding the identification of related parties to certain procedures identified in the ISA. This AUS does not follow that approach, but adopts a risk-based

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approach. Accordingly, compliance with this AUS will not necessarily result in the performance of the same procedures as those set out in ISA 550;

- (b) ISA 550 adopts the definitions given in International Accounting Standard IAS 24 “Related Party Disclosures”, whereas this AUS adopts the definitions given in Accounting Standard AASB 1017 “Related Party Disclosures” and Australian Accounting Standard AAS 22 “Related Party Disclosures”;
- (c) ISA 550 does not contain an equivalent requirement to that of paragraph .07. The Auditing & Assurance Standards Board recognises that substance over form is a fundamental element of the financial reporting framework; and
- (d) the equivalent of paragraph .24 is identified in ISA 550 as a basic principle/essential procedure. The Auditing & Assurance Standards Board, in applying the requirements of AUS 520 “Management Representations”, does not consider that a written representation need be obtained in all circumstances.