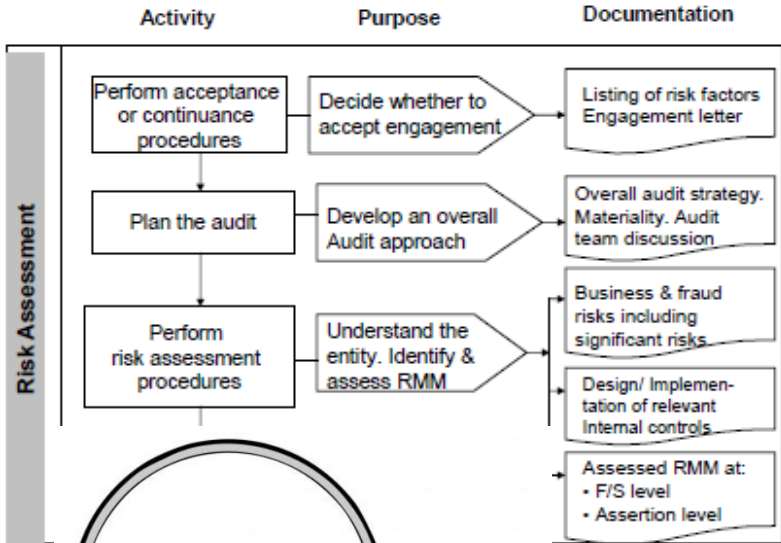


**Audit of Related Party Transactions  
under Standards of Auditing (incl SA 550)  
- CA Manish.P**

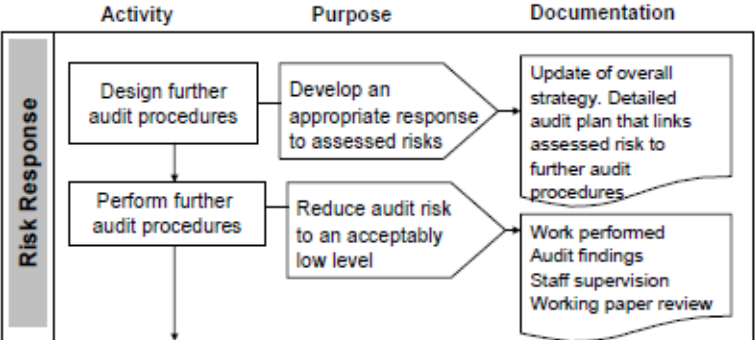
**Mukesh Manish & Kalpesh**  
Chartered Accountants

# Quick Recap: Risk-based Audit of Financial Statements

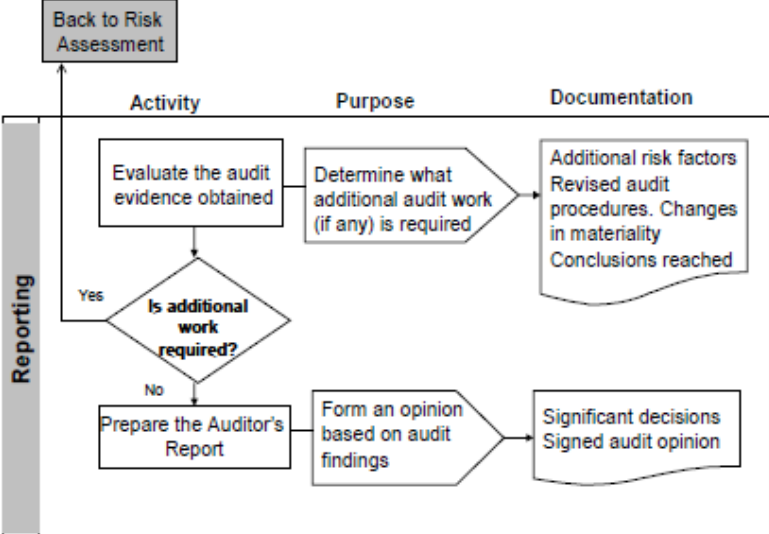
## Risk Assessment



## Risk Response



## Reporting



# Setting the context: Audit under the framework of SA

---

- Assume that the applicable financial reporting framework establishes minimal or no related party requirements.

What is the relevance of the “Related Parties Transactions” (RPT) in the audit of the financial statements?



# Setting the context: Audit under the framework of SA (Contd.)

- Considerations in relation to Related Parties/ RPTs in SAs (examples):

Reference to SAs	Considerations in relation to RPTs in SAs
SA – 315 Identifying and Assessing the ROMM through understanding the entity and its environment	<ul style="list-style-type: none"> <li>• As a part of risk assessment, the auditor is required to determine whether any of the below would be “<b>significant risk</b>”.               <ul style="list-style-type: none"> <li>➤ <i>Whether the risk involves <b>significant transactions with related parties</b>;</i></li> <li>➤ <i>Whether the risk involves significant transactions that are <b>outside the normal course of business</b> for the entity, or that otherwise <b>appear to be unusual</b>.</i></li> </ul> </li> </ul>
SA – 330 Auditor’s responses to assessed risk	<ul style="list-style-type: none"> <li>• Factors relevant to be considered as to whether “external confirmations” are to be performed as substantive audit procedures:  <i>The objectivity of the intended confirming party – if the confirming party is a <b>related party</b> of the entity, responses to confirmation requests may be less reliable.</i></li> </ul>
SA – 240 Auditor’s responsibilities relating to fraud in an audit of financial statements	<ul style="list-style-type: none"> <li>• The Characteristics of fraud which the auditor is concerned with , are explained. Illustrations for misappropriation of assets are enumerated, which includes,  <i>Using an entity’s assets for personal use (for example, using the entity’s assets as collateral for a personal loan or a <b>loan to a related party</b>).</i></li> </ul>

# Setting the context: Audit under the framework of SA (Contd.)

- Considerations in relation to Related Parties/ RPTs in SAs (examples):

Reference to SAs	Considerations in relation to RPTs in SAs
SA – 240 Auditor’s responsibilities relating to fraud in an audit of financial statements	<ul style="list-style-type: none"> <li>• Examples of opportunities that may indicate heightened fraud risk factors are given, which includes: <i>Significant <b><u>related-party transactions not in the ordinary course of business or with related entities not audited or audited by another firm.</u></b></i></li> <li>• Example for specific audit procedures in response to ROMM due to fraud/ mis-appropriation of assets includes:               <ul style="list-style-type: none"> <li>➤ <i>For significant and unusual transactions, particularly those occurring at or near year-end, investigating the <b><u>possibility of related parties</u></b> and the sources of financial resources supporting the transactions.</i></li> <li>➤ <i>Reviewing the authorization and carrying value of loans to senior management and related parties</i></li> </ul> </li> <li>• Indicators that transactions lacking business rationale may be an indicator of fraud risk:               <ul style="list-style-type: none"> <li>➤ <i>Transactions that involve non-consolidated related parties, including special purpose entities, have not been properly reviewed or approved by those charged with governance of the entity.</i></li> <li>➤ <i>The transactions involve previously unidentified related parties or parties that do not have the substance or the financial strength to support the transaction without assistance from the entity under audit.</i></li> </ul> </li> </ul>

# SA 550 (Revised) on Related Parties – Key Aspects

- **Scope:**
  - Auditor's responsibilities regarding related party relationships and transactions **when performing an audit of financial statements**. Not just all about related party disclosures under the applicable accounting standards!!!
- **Key requirements under SA - 550**
  - Identifying Risk of material misstatement (ROMM) associated with related party relationships and transactions.
  - Consideration of laws and regulations w.r.t. the auditee's conduct of business with related parties/ specific financial reporting requirements
    - Companies Act, 2013 – Section 177/Section 188 – Audit Committee/Board/Shareholders approvals
    - Ind AS 24 – Disclosure of information in relation to related party relationships & transactions
    - Income-tax Act, 1961 – Section 40A(2) – Disallowance of expenditure paid/ payable to specified persons to the extent excessive/ unreasonable having regard to the fair market value
    - Income-tax Act, 1961 – Chapter X –International transactions with associated enterprises should comply with arm's length standards
    - Valuation of Supply of Goods & Services in respect of Related Party Transactions under GST Law,
    - Special Valuations Branch (SVB) under the Customs Law
    - SEBI – Approvals and disclosures as required under Listing Obligations and Disclosure Requirements, Regulations.

# SA 550 (Revised) on Related Parties – Key Aspects (Contd.)

- **Key requirements under SA – 550 (Contd.)**

- Understanding the Entity's Related Party Relationships and Transactions - Key aspects

- Process and Controls for identification of related parties, transactions, approvals and statutory compliances
- Emphasis on Professional Skepticism
- Consider the risk of relationships not identified/ disclosed by the management. E.g. - Complex organization structure, special-purpose entities for off-balance sheet transaction, inadequate information system etc.
- Sources of information
  - Entity's ownership and governance structures, Financing arrangements, Investments made.
  - Inquiries with various stakeholders (internal auditor, external legal counsel, compliance/ ethics personnel etc.),
  - Information documents maintained under Statutes (Minutes, Registers, Forms/ Form MBP – 1, Transfer Pricing Documentation etc)
  - Information filed (e.g. Income-tax returns, SVB Correspondences, Master File, Country by Country reporting
  - Tax/ Legal advices sought, agreements and contracts, Annual reports of Holding/ Ultimate Holding Companies
  - Information on the Company/ Group's websites
  - Analytics on outliers (unusually long credit period, interest-free loans, insurance or guarantees etc. received/ issued, offer/ acceptance of deep discounts, unique transactions/ arrangements, free of cost transactions/ reimbursements or recoupments, common assets/ costs etc.)

# SA 550 (Revised) on Related Parties – Key Aspects (Contd.)

- **Key requirements under SA – 550 (Contd.)**

- Identification and addressing of ROMM associated with Related Parties/ Transactions with related parties (RPT)

- Identification of fraud risk factors? Common indicators -

- ✓ Borrowing or lending on an interest-free basis or at a rate of interest significantly above or below market rates;
- ✓ Selling real estate at prices that differ significantly from appraised value;
- ✓ Exchanging property for similar property in a non-monetary transaction;
- ✓ Loans with no scheduled terms for when or how the funds will be repaid.
- ✓ Loans with accruing interest differing significantly from market rates;
- ✓ Loans to parties lacking the capacity to repay;
- ✓ Loans advanced for valid business purpose and later written off as uncollectible;
- ✓ Non-recourse loans to shareholders;
- ✓ Agreements requiring one party to pay the expenses on the other's behalf;
- ✓ Round tripping sales arrangements (seller has concurrent obligation to purchase from the buyer);
- ✓ Business arrangements where the entity pays or receives payments of amounts at other than market values;



# SA 550 (Revised) on Related Parties – Key Aspects (Contd.)

- **Key requirements under SA – 550 (Contd.)**
  - Identification and addressing of ROMM associated with Related Parties/ Transactions with related parties (RPT)
    - Identification of fraud risk factors? Common indicators (Contd.)
      - ✓ Failure to adequately disclose the nature and amounts of related party relationships and transactions as required by GAAP ;
      - ✓ Consulting arrangements with directors, officers or other members of management;
      - ✓ Land sales and other transactions with buyers of marginal credit risk;
      - ✓ Monies transferred to or from the company from a related party for goods or services that were never rendered;
      - ✓ Goods purchased or sent to another party at less than cost;
      - ✓ Material receivables or payables from to or from related parties such as officers, directors and other employees;
      - ✓ Discovery of a previously undisclosed related party;
      - ✓ Large, unusual transactions with one or a few other parties on or at period end; and
      - ✓ Sales to high-risk jurisdictions or jurisdictions where the entity would not be expected to conduct business

# SA 550 (Revised) on Related Parties – Key Aspects (Contd.)

- **Key requirements under SA – 550 (Contd.)**

- Identification and addressing of ROMM associated with Related Parties/ Transactions with related parties (RPT)

- Identification of fraud risk factors? Audit Procedures

- ❖ Conducting public records searches/background investigations on customers, suppliers and other individuals to identify related parties and confirm legitimacy of business;
- ❖ Performing data mining to determine whether transactions appear on computerized files;
- ❖ Performing document review of identified transactions to obtain additional information for further inquiry;
- ❖ Searching for unusual or complex transactions occurring close to the end of a reporting period;
- ❖ Searching for significant bank accounting or operations for which there is no apparent business purpose;
- ❖ Reviewing the nature and extent of business transacted with major suppliers, customers, borrowers and lenders to look for previously undisclosed relationships;
- ❖ Reviewing confirmations of loans receivable and payable for indications of guarantees;
- ❖ Performing alternative procedures if confirmations are not returned or returned with material exceptions;
- ❖ Reviewing material cash disbursements, advances and investments to determine if the company is funding a related entity;
- ❖ Testing related party sales to supporting documentation (i.e., contract and sales order) to ensure appropriately recorded;

# SA 550 (Revised) on Related Parties – Key Aspects (Contd.)

- **Key requirements under SA – 550 (Contd.)**
  - Identification and addressing of ROMM associated with Related Parties/ Transactions with related parties (RPT) (Contd.)
    - Identification of fraud risk factors? Audit Procedures (Contd.)
      - ❖ Discussing with counsel, prior auditors and other service providers the extent of their knowledge of parties to material transactions; and
      - ❖ Inquiring about side agreements with related parties for right of return or contract cancellation without recourse

# SA 550 (Revised) on Related Parties – Key Aspects (Contd.)

- **Key requirements under SA – 550 (Contd.)**

- Identification and addressing of ROMM associated with Related Parties/ Transactions with related parties (RPT) (Contd.)

- Dominant influence in case of RPT? Indicators for the same-
  - Veto of significant business decisions taken by management or Those Charged with Governance (TCWG) by a related party
  - Significant transactions are referred to the related party for final approval
  - There is little or no debate among management and those charged with governance regarding business proposals initiated by the related party.
  - Transactions involving the related party (or a close family member of the related party) are rarely independently reviewed and approved.
  - The related party has played a leading role in founding the entity and continues to play a leading role in managing the entity
  - Unusual high turnover of senior management or professional advisors
  - The use of business intermediaries for significant transactions without clear business justification
  - Related party's excessive participation in selection of accounting policies or determination of significant estimates

# SA 550 (Revised) on Related Parties – Key Aspects (Contd.)

- **Key requirements under SA – 550 (Contd.)**

- Identification and addressing of ROMM associated with Related Parties/ Transactions with related parties (RPT) (Contd.)
  - Dominant influence in case of RPT? Evaluation of substance of the transaction? Basis of determination of pricing?
    - Designing and Performance of further audit procedures
    - Independent discussion with intermediaries (Banks, Law firms, Guarantors, Agents etc.)
    - Specifically tailored confirmations (e.g. purpose, terms of the arrangements, risks and rewards, amounts etc.)
    - Consideration of financial and other information of the related parties
    - Inquiries with the management, TCWG, related parties
    - Inspection of contracts and other evidences to support the actual conduct of the parties
    - Background checks
    - Internal audit, Whistle blower complaints/ reports, Orders of Statutory Authorities (Transfer Pricing, SVB etc.)
  - Risk of Undisclosed Parties/ Transactions
    - Consideration of information from various sources
    - Inquiries into unusual transactions/ outliers/ agreements with unique terms and conditions/ lacking rationale

# SA 550 (Revised) on Related Parties – Key Aspects (Contd.)

- **Key requirements under SA – 550 (Contd.)**

- Consideration of the overall, pervasive and specific impact in case of identification/ unearthing of any new relationships/ RPTs during the course of the audit

- Communication within the engagement team (including experts)
- Consideration of Materiality and Significance
- Impact on the company's controls w.r.t. identification of related parties
- Additional risks (including fraud risks) to be identified?
- Conclusions on controls testing? Impact on reporting on internal financial controls?
- Risk of possible non compliances? Impact of the same in the financial statements/ audit?
- Control reliance strategy valid anymore? Additional substantive audit procedures
- Communication to appropriate levels of the Management/ TCWG
- Conclusion and reporting

- Assertion in relation to arm's length

While various statutes provides that the transactions with related parties should be entered into at arm's length price (ALP), guidance on the manner in which ALP is to be determined is available only in the Income-tax Act, 1961 (Chapter X) and Income-tax Rules, 1962 (Rule 10B).

# SA 550 (Revised) on Related Parties – Key Aspects (Contd.)

- **Key requirements under SA – 550 (Contd.)**

- Assertion in relation to arm's length (Contd.)

Rule 10B provides for determination of ALP by any of the following methods, being “most appropriate method” to the facts and circumstances:

- (i) Comparable Uncontrolled Price (CUP)
- (ii) Resale Price Method (RPM)
- (iii) Cost Plus Method (CPM)
- (iv) Profit Split Method (PSM)
- (v) Transactional Net Margin Method (TNMM)
- (vi) Other Method

### **Audit Procedures:**

- Management's Process of fixing the price and evaluation of arm's length – assessment of appropriateness/reasonableness thereof.
- Verifying the source of the internal or external data supporting the assertion, and testing the data to determine their accuracy, completeness and relevance.
- Evaluating the reasonableness of any significant assumptions on which the assertion is based.

# SA 550 (Revised) on Related Parties – Key Aspects (Contd.)

- **Key requirements under SA – 550 (Contd.)**
  - Assertion in relation to arm's length (Contd.)
    - Comparison of terms and pricing with identical/ similar transactions with one/ more third parties
    - Consideration of information in relation to open market price/ available in the public domain
    - Engagement of experts for determination of market value/ arm's length price

## Examples for related party transactions and possible ways for evaluation of arm's length:

Transactions	Possible ways for evaluation of arm's length
Sale of Goods	<ul style="list-style-type: none"><li>• The price (and terms) at which same/ similar goods are sold to third parties</li><li>• Standard Price list/ Pricing Policy</li><li>• Market Price of the goods</li><li>• Comparison of gross margins in the tested transaction vis-à-vis similar transactions with third parties</li><li>• Comparison of gross margins in the tested transaction vis-à-vis gross margins earned by comparable companies in transactions with independent parties</li><li>• Comparison of operating margins in the tested transaction vis-à-vis operating margins prescribed under Safe Harbour Rules (Transfer Pricing) / Net margins earned by comparable companies in transactions with independent parties</li></ul>



# SA 550 (Revised) on Related Parties – Key Aspects (Contd.)

Examples for related party transactions and possible ways for evaluation of arm's length:

Transactions	Possible ways for evaluation of arm's length
Availing Services	<ul style="list-style-type: none"> <li>• Similar to “Sale of Goods” discussed above. Additionally, ascertaining the need, benefit and actual receipt of services may also be an important aspect.</li> </ul>
Leasing of Premises/ Land and building	<ul style="list-style-type: none"> <li>• Market rent for similar properties in the same area based on publicly available information, like websites where properties are listed for leasing</li> <li>• Annual rental value (fixed by the local authorities for levy of taxes), subject to the same being a fair representative of the market rent and are up-to-date</li> <li>• Professional rental assessment (Direct Comparison approach, Land yield assessment approach etc.)</li> </ul>
Fee for Corporate Guarantee	<ul style="list-style-type: none"> <li>• It is important to understand the rationale behind one entity providing guarantee to the borrowings of the other entity.</li> <li>• Where the guarantee has resulted in borrowing at cheaper interest rate, the fee for guarantee may be fixed at a fair share of savings in interest on account of furnishing the guarantee.</li> <li>• Where the guarantee has enabled the other entity to borrow funds, guarantee charges that would have been charged by banks/ financial institutions, duly factoring in the relevant aspects like credit rating of the borrower, credit risk etc. may be a good indicator of arm's length price.</li> </ul>

# SA 550 (Revised) on Related Parties – Key Aspects (Contd.)

- **Key requirements under SA – 550 (Contd.)**

- Evaluation of appropriate accounting and disclosure

- Business rationale and substance of the transactions
- Key terms, conditions, or other important elements of the transactions
- Effect on the financial statements (including disclosures)
- Hidden costs/ off balance sheet exposures

- Written Representations

- Disclosure of identity, appropriate accounting and disclosure
- Key Terms and Conditions in respect of the transactions, Consistent conduct of the parties
- Need , benefit and actual utilization in the case of Services.
- Arm's length pricing.

# Learnings from Regulatory reviews – Aspects w.r.t RPTs

Reference to Order/ Standards	Topic in relation to the observations	Explanations
	Lapses in audit relating to fraudulent transactions with related party (MAECL)	<p>The company was involved in evergreening of loans and round tripping of funds with the ulterior motive of understating the loan to MACEL. These loans were never repaid by the group companies, but financial statements were manipulated to conceal the real picture. The financial positions of MACEL showed that it had negligible business operations, had negative net worth, and was used as conduit by promoters to siphon off money from company. These were sufficient evidence that MACEL lacked the financial strength to repay loans and accordingly recognition of impairment loss allowance and writing off of non-recoverable portion of loans was required to be made but Company did not do so and the Auditors did not question the management and did not perform any audit procedures to obtain sufficient and appropriate audit evidence to determine whether CDGL's decision in this regard was in accordance with provisions of IND AS 109. Therefore, it was held that the charge on this count stands proved and uphold that the Auditors have violated section 143(3) (e), 143(12) of the Act, CARO 2016 and SA 200, SA 240, SA 315, SA 330 and SA 550.</p>

# Learnings from Regulatory reviews – Aspects w.r.t RPTs (Contd.)

Reference to Order/ Standards		Topic in relation to the observations	Explanations
Audit Review Report - Infrastructure Leasing & Financial Services Limited (ILFS)	Quality (AQR)	Lapses in Audit of Loans and Advances	The audit of loans and advances at IL&FS, amounting to Rs. 8,124 Crore disbursed to 26 related parties, exposed serious non-compliance with SA 550. The audit firm violated Section 177 of the Companies Act, 2013, governing related party transactions, and failed to mitigate risks associated with management override, evergreening, and loan rollovers. Furthermore, the audit documentation was found inadequate, lacking sufficient evidence of procedures performed, thereby compromising the reliability and integrity of the audit process as mandated by SA 550.
SA 550			

# Learnings from Regulatory reviews – Aspects w.r.t RPTs (Contd.)

Reference to Order/ Standards	Topic in relation to the observations	Explanations
<p>NFRA Order - Women Next Loungeries Limited (WNLL)</p> <p>SA 550 – Para 18</p>	<p>Failure to evaluate the arm's length basis for transactions with related parties.</p>	<p>As per para 18 of SA 550 - Related Parties "In meeting the SA 315 requirement to identify and assess the risks of material misstatement the EP is required to identify and assess the risks of material misstatement associated with related party relationships and transactions and determine whether any of those risks are significant risks". Further, as per para 24 of SA 550, when management has made an assertion in the financial statements to the effect that a Related Party Transaction was conducted on terms equivalent to those prevailing in an arm's length transaction, the auditor shall obtain sufficient appropriate audit evidence about the assertion.</p> <p>As there is no testing of the arm's length pricing in the Audit File and the reply of the EP did not specifically answer the charge in the SCN, we conclude that the EP did not comply with requirements of SA 550.</p>
<p>Lexus Granito India Ltd (LGIL)</p> <p>SA 550</p>	<p>Related party Transaction</p>	<p>The Auditors failed to obtain sufficient appropriate audit evidence for the audit of related party transactions of the company. Approximately 44% of the Initial Public Offer ('IPO' hereafter) proceeds were paid to one of its related parties, however, no sufficient appropriate documentation of audit procedures for verification of utilisation of IPO proceeds was found in the Audit File, except for a list of payments out of IPO proceeds.</p>

# Learnings from Regulatory reviews – Aspects w.r.t RPTs (Contd.)

Reference to Order/ Standards	Topic in relation to the observations	Explanations
Financial Reporting Quality Review - PSP Projects Limited	Non-disclosures regarding Related Party Loans	<p>The company disclosed loans totaling Rs. 3,942.63 lakhs to related parties, with Rs. 2,751.59 lakhs classified as non-current and Rs. 1,163.44 lakhs classified as current. However, the full particulars of these loans, including the rate of interest, repayment terms, due date, collateral, etc., were not disclosed in the Financial Statements, as required by Section 186(4) of the Companies Act 2013 and Schedule III of the Companies Act, 2013. The Company acknowledged this oversight and mentioned that they disclosed the transactions conducted during the year, year-end balances related to loans and guarantees provided to related parties, and interest income recognized under Note No. 37 pertaining to related party transactions. However, they did not specifically reference Section 186(4) of the Companies Act, 2013.</p> <p>During the in-person discussion, the Company assured that it had taken note of NFRA's observation and had improved the disclosures in the Financial Statements from 2021-22 in line with the Companies Act, 2013, and Schedule III. Moving forward, the company was directed to disclose the loan tenure and any collateral provided, if applicable, to ensure comprehensive and compliant disclosure practices.</p>

**Mukesh Manish & Kalpesh  
Chartered Accountants**

7th Floor, Briley One,  
No. 30/ 64 Ethiraj Salai,  
Egmore, Chennai – 600 008,  
Tamil Nadu, India

**Ph No:** +91-44-4263 9000

**Email:** [auditqrm@m2k.co.in](mailto:auditqrm@m2k.co.in)

**Thank you**