

Exposure Draft of the Standard on Internal Audit (SIA), *Related Parties* (Last Date for Comments is April 30, 2012)

Invitation to Comments:

The Internal Audit Standards Board of the Institute of Chartered Accountants of India invites comments on the Exposure Draft of the Standard on Internal Audit (SIA), *Related Parties*. Comments are most helpful if they indicate the specific paragraph(s) to which they relate, contain a clear rationale and, where applicable, provide a suggestion for alternative wording.

Comments should be submitted in writing to the Secretary, Internal Audit Standards Board, The Institute of Chartered Accountants of India, ICAI Bhawan, A-29, Sector-62, NOIDA - 201 309 so as to be received not later than **April 30, 2012**. Comments can also be sent by e-mail at cia@icai.org.

Introduction

1. The purpose of this Standard on Internal Audit is to establish standard and provide guidance on the procedures to be followed by the internal auditor in ensuring that related party activities of the entity are properly captured through internal controls; and that related party activities are consistent with the entity's code of conduct and conflict of interest policy, applicable laws and regulations and disclosure requirements.

2. Management is responsible for the identification and disclosure of related parties and accounting for the related party transactions. This responsibility requires management to implement adequate internal control to ensure that transactions with related parties are appropriately identified, recorded and disclosed in the financial statements. The internal auditor is the appropriate resource for assessing what management has implemented with regard to related party information by evaluating relevant internal controls and inform the management about the deficiencies detected.

Related Party

3. Related party is either:

- (i) A related party as defined in the applicable laws or regulations; or
- (ii) Where the applicable laws or regulations establish 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 common controlling ownership, or owners who are closely family members or 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.

4. Control is the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities and 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:

- (a) Direct or indirect equity holdings or other financial interests in the entity.
- (b) The entity's holding of direct or indirect equity or other financial interests in other entities.
- (c) Being part of those charged with governance or key management (i.e., those members of management who have authority and responsibility for planning, directing, and controlling the activities of the entity).

- (d) Being a close family member of any person referred to in sub-paragraph (c).
- (e) Having a significant business relationship with any person referred to in sub-paragraph (c).
- (b) The nature of the relationships between the entity and these related parties; and
- (c) Whether the entity entered into any transactions with these related parties during the period and, if so, the nature and the purpose of the transactions.

Related Party Transactions

5. A related party transaction is a transfer of resources, services or obligations between an entity and a related party, regardless of whether a price is charged. Transactions that because of their nature may be indicative of the existence of related parties include:

- (a) Borrowing or lending on an interest-free basis or at a rate of interest significantly above or below market rates prevailing at the time of the transaction.
- (b) Buying/selling transactions at a price that differs significantly from its appraised value.
- (c) Exchanging property for similar property in a non-monetary transaction.
- (d) Making loans with no scheduled terms of repayment.
- (e) Granting of a guarantee without adequate compensation.

6. Related party transactions may not be conducted under normal market terms and conditions at all times. There may be possibility that transactions with related parties may have been motivated solely, or in large measure, by conditions similar to the following:

- (a) Lack of sufficient working capital or credit to continue the business;
- (b) An urgent desire for a continued favorable earnings record in the hope of supporting the price of the company's share;
- (c) An overly optimistic earnings forecast;
- (d) Depending on a single or relatively few products, customers, or transactions for the continuing success of the venture;
- (e) Excess capacity;
- (f) Significant litigation, especially, litigation between shareholders and management;
- (g) A declining industry characterized by a large number of business failures;
- (h) Significant technology obsolescence.

Internal Audit Procedures

7. The internal auditor shall perform the internal audit procedures and related activities to obtain information relevant to evaluating internal controls associated with related party relationships and transactions. The internal auditor shall gather the following information pertaining to related party relationships and transactions:

- (a) The identity of the entity's related parties including changes from the prior period;

8. The following may be considered by the internal auditor while understanding the entity's related party relationships and transactions:

- (a) The nature and extent of the entity's relationships and transactions with related parties.
- (b) An emphasis on the importance of maintaining due professional care throughout the audit regarding the potential for material misstatement associated with related party relationships and transactions.
- (c) The circumstances or conditions of the entity that they indicate the existence of related party relationships or transactions that management has not identified or disclosed to the internal auditor (for example, a complex organizational structure, use of special-purpose entities for off-balance sheet transactions, or an inadequate information system).
- (d) The records or documents that may indicate the existence of related party relationships or transactions.
- (e) The importance that management and those charged with governance attach to the identification, appropriate accounting for, and disclosure of related party relationships and transactions, and the related risk of management override of relevant controls.

9. The internal auditor shall inspect the following for indications of the existence of related party relationships or transactions that management has not previously identified or disclosed:

- (a) Bank and legal confirmations obtained as part of the internal auditor's procedures;
- (b) Minutes of the meetings of the shareholders and of those charged with governance; and
- (c) Such other records or documents as the internal auditor considers necessary in the circumstances of the entity, for example:
 - Entity income tax returns.
 - Information supplied by the entity to regulatory authorities.
 - Shareholder registers to identify the entity's principal shareholders.
 - Statements of conflicts of interest from management and those charged with governance.
 - Records of the entity's investments and those of its pension plans.

- Contracts and agreements with key management or those charged with governance.
- Significant contracts and agreements not in the entity's ordinary course of business.
- Specific invoices and correspondence from the entity's professional advisors.
- Life insurance policies acquired by the entity.
- Significant contracts re-negotiated by the entity during the period.
- Documents associated with the entity's filings with a securities regulator (e.g., prospectuses).

If the internal auditor identifies significant transactions outside the entity's normal course of business then the internal auditor shall obtain information about the nature of these transactions and whether the related parties are involved.

10. In smaller entities, the identification of related party transactions can often be difficult. If the entity uses a standard software package to record transactions, consider obtaining an electronic copy of the transactions and importing them into an electronic spreadsheet. By using the sort feature and configuring the selection criteria, it may be possible to obtain information about customers/suppliers with only a few, but large, transactions, or those with significant transactions of a size or nature that is unusual.

11. In responding to the identified risks of material misstatement associated with related party relationships and transactions, the internal auditor would consider the following:

- (a) Determine whether underlying circumstances confirm their existence;
- (b) Promptly communicate the information to the engagement team;
- (c) Request management to identify all the transactions with the related party;
- (d) If related party was not previously identified, consider:
 - failure of any related party identification controls, and
 - fraud (non-disclosure by management appears intentional);
- (e) Reconsider the risk that the other undisclosed related parties or significant related party transactions may exist, and perform additional internal audit procedures as necessary; and
- (f) Perform appropriate substantive internal audit procedures.

12. With regard to significant related party transactions outside normal course of business, the internal auditor should inspect underlying contracts or agreements, if any, and evaluate whether:

- (a) **Rationale suggests possible fraudulent financial reporting or concealment of misappropriated assets,**
- (b) **Terms are consistent with management's explanations, and**
- (c) **Transactions are accounted for and disclosed in accordance with the generally accepted accounting principles,**
- (d) **Ensure transactions have been appropriately authorized and approved.**

13. The internal auditor should obtain sufficient appropriate audit evidence about management's assertion that a related party transaction was conducted on terms equivalent to those prevailing in an arm's length transaction. Evaluating management's support for this assertion may involve one or more of the following:

- (a) Considering the appropriateness of management's process for supporting the assertion.
- (b) Verifying the source of the internal or external data supporting the assertion, and testing the data to determine their accuracy, completeness and relevance.
- (c) Evaluating the reasonableness of any significant assumptions on which the assertion is based.

14. The internal auditor should consider the following matters:

- (a) **Document the names of the identified related parties and the nature of the related party relationships; and**
- (b) **Communicate with those charged with governance, or relevant Committee thereof, such as, audit committee, any significant matters arising during the internal audit in connection with related parties.**

15. The internal auditor would consider the impact on the internal audit report if it is not possible to obtain sufficient appropriate audit evidence concerning related parties and transactions.

Effective Date

16. This Standard on Internal Audit will apply to all internal audits commencing on or after Earlier application of the SIA is encouraged. ■