

Potential Risks of Related Party Transactions (“RPTs”) and Its Impact on Audit

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What are RPTs?

RPTs represent a transfer of resources, services or obligations between related parties, regardless of whether a price is charged.

Parties are considered to be related if one party has the ability, directly or indirectly, to control the other party or exercise significant influence over the other party in making financial and operating decisions. Parties are also considered to be related if they are subject to common control or common significant influence. Related parties also include key management personnel of the company and their close family members.

For example, transactions (e.g. sales, purchases or advances) with companies controlled by the directors, associates, joint ventures, the enterprise’s key management personnel and major shareholders are considered as examples of RPTs.

Why disclosure requires for RPTs?

RPTs are quite a normal practice in commerce and business world. For instance, an entity carries on parts of its activities through subsidiaries, joint ventures and associates. Due to the relationships between the parties, the entity may be able to affect the financial and operating policies of the investee companies through the presence of control, joint control or significant influence. They may enter into transactions with the pricing policies, manner of settlement and other terms of the transactions different from those with independent third parties. For example, an entity may manipulate its profits by selling goods to its related parties at a more favourable price in order to shift its profit from a high tax regime to a lower one. The entity can also make fraudulent financial reporting or to conceal misappropriation of assets by arranging RPTs.

For the above reasons, it is crucial to have knowledge of the RPTs as it may affect the assessments of an entity’s operations by users of financial statements, including assessments of the risks and opportunities facing the entity. Failure to identify and disclose significant RPTs may lead to misstatement of the financial statements and obstruct the financial statements from giving a true and fair view of the state of affairs of the entity and of the results of its operation. Accordingly, RPTs are always a critical audit area that auditors need to pay special attention during the course of the audit of an entity’s financial statements. Especially when significant RPTs are not in the ordinary course of business or with related entities not audited or audited by another firm.

Any potential risk in auditing RPTs?

Management is responsible for the identification and disclosure of related parties and transactions with such parties. This responsibility requires management to implement adequate

internal control to ensure that transactions with related parties are appropriately identified in the information system and disclosed in the financial statements. However, either because of the management is not familiar with the definition of RPTs under the Hong Kong Financial Reporting Standards or inadequate internal control system with respect to the recording and reporting of RPTs, auditors is required to apply procedures to evaluate the completeness of the RPTs.

What will auditors do in auditing the RPTs?

Though, an audit cannot be expected to detect all related party transactions, auditors are still required to carry out audit procedures designed to obtain sufficient appropriate audit evidence regarding the identification and disclosure by management of related parties and the effect of related party transactions that are material to the financial statements.

When obtaining an understanding of the entity's internal control, auditors may consider the adequacy of control activities over the authorisation and recording of related party transactions. Auditors will review information provided by the management identifying the names of all known related parties and transactions with them. In order to ensure its completeness of this information, auditors may perform the following audit procedures:

- (a) Reviewing the minutes of the meetings of shareholders and other relevant statutory records such as the register of directors' interests;
- (b) Inquiring the affiliation of directors and officers with other entities;
- (c) Performing detailed tests of transactions and balances;
- (d) Reviewing accounting records for large or unusual transactions or balances, paying particular attention to transactions recognized at or near the end of the reporting period;
- (e) Reviewing confirmations of loans receivable and payable and confirmations from banks. Such a review may indicate guarantor relationship and other RPTs;
- (f) Reviewing investment transactions, for example, purchase or sale of an equity interest in a joint venture or other entity;
- (g) Checking background of parties which have material unusual transactions with the enterprise by performing company search;
- (h) Obtaining an understanding of the business purpose of the transactions and determine the methods of establishing terms of transactions and consider the effect of transactions with the related parties;
- (i) Obtaining information on the financial capabilities of the related parties which would bear upon the parties' ability to meet their obligations; and
- (j) Circularizing confirmations on significant aspects of transactions and balances, including the nature of the relationship, the terms and amount of the transaction and manner of settlement of outstanding balances.

If you encounter any issues in carrying on businesses with related parties, please don't hesitate to consult your auditors or tax consultants for technical advices.