



Sri Lanka Accounting and Auditing Standards Monitoring Board

Thematic Audit Inspection on Related Parties

December 2021

Director General's Message

Sri Lanka Accounting and Auditing Standards Monitoring Board (SLAASMB), as the sole independent audit regulator in the country, is committed to ensure the audit market environment is being strengthened over the years, with compliance and continuous improvement in the audit processes.

With this objective in mind, SLAASMB has been adopting different regulatory mechanisms to induce compliance with Sri Lanka Auditing Standards by the auditors of economically significant entities. These approaches have taken different phases over the years with the aim of improving the overall audit processes and aligning with global best practices.

Accordingly, SLAASMB has been conducting Thematic Audit Inspections as part of the audit regulatory activities, and the findings are communicated by way of publishing a report. Thematic audit inspections are generally more focused in scope and considers selected areas in greater depth than in the regular inspections of the audit.

SLAASMB has been observing a higher frequency of findings related to Related Parties, from the reviews of financial statements. In this respect, as the auditor is also vested with a responsibility to conduct the audit according to the auditing standard on Related Parties, the theme Related Parties was selected for the fourth Thematic Audit Inspection.

This report serves as an educational tool to auditors as it describes the current practices and highlights the good practices. It also acknowledges the auditors who have adopted commendable practices and encourage firms to reach greater heights in quality and serve as a means of guiding the auditors who require to improve their

processes. Further, with this report being shared with listed companies and their Related Party Transactions Review Committees, we expect this to be a source that would strengthen the functions of Financial Reporting by enabling proper identification and disclosure of related party relationships and transactions to enhance greater transparency.

On behalf of SLAASMB, I take this opportunity to thank the four (4) audit firms which were subject to the Thematic Inspection during 2019 for their active co-operation, and to the dedicated staff of SLAASMB for the tireless effort put into the planning and conducting of the audit inspections as this is the first time this theme was selected for such a review, and for analyzing and reporting the findings in particular. Further, I trust that this report will be a useful guide for all auditors including the auditors of tomorrow.

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Director General

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1. Executive Summary

Sri Lanka Accounting and Auditing Standards Monitoring Board (SLAASMB) conducted a thematic audit inspection on the theme “Related Parties” during the year 2019, to get an understanding on how the auditors have dealt with their responsibility relating to Related Party relationships and transactions in an audit of financial statements in accordance with Sri Lanka Auditing Standard SLAuS 550, Related Parties. SLAASMB’s more frequent observations on inadequate disclosures on the transactions entered by Related Parties which resulted in non-compliance with Sri Lanka Accounting Standard LKAS 24, Related Party Disclosures, by Specified Business Enterprises (SBEs) lead SLAASMB to conduct the thematic audit inspection on the said theme.

Detecting Related Party relationships and transactions are not always easy, especially in the circumstances where complex group structures exist coupled with lack or absence of effective internal controls. Therefore, the audit of Related Party relationships and transactions have become a challenge to auditors.

This report explores the compliance with SLAuS 550 by 4 audit firms, of the selected sample of the SBEs, which are listed in the Colombo Stock Exchange.

All firms have used the guidance given in SLAuS 550, requiring focus on the auditor’s attention on the risk of material misstatements that may arise due to the existence of Related Party relationships and transactions. In order to achieve the objective of the said Standard, auditors have performed various audit procedures.

However, due to most of the entities adopting manual controls over identification of related parties and their transactions, auditors have relied more on substantive audit procedures rather than on control reliance.

All auditors have made an effort to understand the entity’s Related Party relationships and transactions by way of performing many audit procedures such as, discussing with previous engagement partner, discussing within the engagement team, discussing with the management and Audit Committees and perusing certain documents (i.e share register, tax returns, CSE announcements) etc.

Nevertheless, SLAASMB observed, auditors not making efforts to have effective communication with the Related Party Transaction Review Committee and with the internal auditors of the entity. Further the auditor could have obtained an understanding of the entity’s Related Parties and their transactions by way of having discussions with other divisions of the firm, if the firm is providing non-audit services to the same entity.

2. Preface

SLAASMB monitors compliance with Sri Lanka Auditing Standards by the auditors of economically significant entities when conducting audits of financial statements. As part of SLAASMB's objective on enhancing the audit quality in Sri Lanka, SLAASMB introduced thematic audit inspections in 2017. Conduct of the thematic audit inspections results in identifying and highlighting the best practices followed by selected firms and areas which needs improvements, based on a selected theme. The findings of the thematic audit inspection are published by way of a Thematic Report to share the knowledge among all interested parties/ stakeholders of SLAASMB.

Thematic audit inspections are deliberately narrow in scope, and are chosen to focus on a specific aspect of the audit in a greater depth than generally possible in regular inspection of audits.

A thematic audit inspection looks at the application of firms' policies and procedures in respect of a specific area or aspect of the audit to make comparisons among audit firms, with a view of identifying both good practices and areas of common weaknesses.

The areas focused in the previous thematic audit inspections conducted by SLAASMB are:

- Work of Engagement Quality Control Reviewer - 2017
- Communication had with Those Charged with Governance – 2017 and 2018

Reports on these reviews are available at <http://slaasmb.gov.lk>.

SLAASMB is the sole regulator monitoring compliance with accounting and auditing standards by SBEs and their auditors respectively in Sri Lanka. At present, there are approximately

over 1,600 private and public entities and 70 audit firms coming within the pervue of SLAASMB. Based on the past data gathered by SLAASMB, on findings of financial statement reviews carried out, SLAASMB observed frequent occurrences of non-compliances in relation to Sri Lanka Accounting Standard LKAS 24, Related Party Disclosures. Considering the importance of the identification and disclosure of Related Parties and Related Party transactions in accordance with LKAS 24, SLAASMB decided to conduct a thematic audit inspection on the theme "Related Parties" during the year 2019.

SLAASMB considers this thematic audit inspection to be of value to audit firms as the findings contributes in developing or enhancing the performance of the audit procedures to identify, assess as well as to respond to the possible material misstatements arising from entity's failure to appropriately account or/and disclose Related Party relationships, transactions or balances in accordance with LKAS 24. It would also be of interest to Audit Committees and Related Party Transaction Review Committees, to enhance entity's internal control efficiencies in identifying Related Party relationships and transactions and in documenting and summarizing transactions and outstanding balances between the entity and its Related Parties.

SLAASMB appreciates the co-operation extended by each audit firm and the staff of firms during the conduct of the inspections, by providing necessary information including firm's methodologies and global quality requirements in relation to the focus area.

SLAASMB is enthusiastic towards maintaining a smooth interrelationship among the auditor - regulator - auditee in its future endeavors as well.

3. Background and Scope

3.1 Background

SLAASMB introduced thematic audit inspections in 2017 as an independent exercise of value addition to the regular audit inspection program.

A thematic audit inspection focus on firms' policies and procedures in respect of a specific area or aspect of the audit, by inspecting selected audit engagements of such firm. This facilitates comparisons among firms with a view to identifying both good practices and areas of improvements in relation to the selected theme or specific area.

This report sets out the principal findings of the thematic audit inspection conducted by SLAASMB during 2019.

Related Party transactions are legitimate activities and serves practical purposes. However, transactions with Related Parties could pave way to mislead financial information in financial statements and conceal the economic substance of transactions or fraud in entities. Accordingly, the nature of the Related Party relationship and transactions may, in some circumstances give rise to higher risks of material misstatements than transactions with Un - Related Parties.

Considering the increase in the complexity of Related Party transactions operating through extensive and complex structures, certain standards, rules and regulations such as Accounting Standards, Auditing Standards, Code of Best Practices, Listing Rules etc. has been implemented by standard setters and regulators of the financial reporting eco system. The said thematic audit inspection, centers primarily on the requirements laid down by Sri Lanka Auditing Standard SLAuS 550, Related Parties and Sri Lanka Accounting Standard LKAS 24, Related Party Disclosures.

The audit of Related Party relationships and transactions is a difficult and yet an important part of the audit. Regardless of whether the applicable financial reporting framework establishes Related Party requirements, SLAuS 550 deals with the objectives in obtaining an understanding of Related Party relationships and transactions by the auditor. Based on the understanding obtained, the auditor should assess fraud risk indicators, and conclude on the appropriateness of the accounting treatment and disclosures applied to Related Parties and to their transactions.

The objectives of the auditor are:

- (a) Irrespective of whether the applicable financial reporting framework establishes related party requirements, to obtain an understanding of related party relationships and transactions sufficient to be able:**
 - (i) To recognize fraud risk factors, if any, arising from related party relationships and transactions that are relevant to the identification and assessment of the risks of material misstatement due to fraud;
 - and
 - (ii) To conclude, based on the audit evidence obtained, whether the financial statements, insofar as they are affected by those relationships and transactions:
 - a. Achieve fair presentation (for fair presentation frameworks);
 - or
 - b. Are not misleading (for compliance frameworks); and
- (b) In addition, where the applicable financial reporting framework establishes related party requirements, to obtain sufficient**

appropriate audit evidence about whether related party relationships and transactions have been appropriately identified, accounted for and disclosed in the financial statements in accordance with the framework.

(SLAuS 550 P 9)

The nature of the Related Party relationships and transactions could lead to a high-risk of material misstatements. Therefore, it is particularly significant to the auditor's risk assessment and to the response of the assessed risk.

Following can be considered as few examples for reasons for increase in risk relating to Related Party transactions:

- Many entities operate through a complex range of relationships and structures, and the complexity of Related Party transactions is increasing;
- Existence of all Related Party relationships and transactions are not known to the management;
- Related Party transactions may not be conducted under normal market terms and conditions;
- The entity's information systems may not identify transactions or outstanding balances with Related Parties;
- Related Party transactions may be intentionally concealed by management, and their accounting treatment may carry a high risk of deliberate manipulation.

Thus, the audit of Related Party relationships and transactions have become a challenge to auditors since identifying Related Party relationships and transactions are not always easy, especially in the circumstances where the Related Party transactions are considered to be of high risk.

This thematic audit inspection has considered the auditor's responsibilities relating to Related Party relationships and transactions in an audit of financial statements, at the engagement level.

While Sri Lanka Auditing Standard SLAuS 550, Related Parties, highlights the responsibilities of the auditor, Sri Lanka Accounting Standard LKAS 24, Related Party Disclosures ensures that an entity's financial statements contain the disclosures necessary to draw attention to the possibility that its financial position and financial performance may have been affected by the existence of Related Parties and by their transactions. Further, certain best practices stipulated in the Code of Best Practice on Corporate Governance (Corporate Governance Code) can be considered as good insights to be followed by entities in order to ensure that the interests of shareholders as a whole, are taken into account by an entity, when entering into Related Party transactions. The Code of Best Practice highlights the importance of considering the economic and commercial substance of the Related Party transactions instead of legal form and technicality. The Colombo Stock Exchange (CSE) listing rules has mandated listed entities to have a Related Party Transactions Review Committee (RPTRC) with effect from 1 January 2016.

A listed entity is required to comply with Corporate Governance best practices as a continuing listing requirement of the CSE. The Corporate Governance Code requires a RPTRC to be formed where the primary function of the Committee is to review Related Party transactions as prescribed by Section 9 of the Listing Rules of the Colombo Stock Exchange.

RPTRC is required to have written terms of reference stating clearly, its authority and duties, mainly covering aspects of;

- *Having a procedure*
 - ✓ to document and identify Related Parties in accordance with the definitions in LKAS 24 and the CSE Listing Rules
 - ✓ to obtain a statement of Related Party interest from each of such Related Party at least once in each quarter

- ✓ to document and identify recurrent and non-recurrent Related Party transactions and to obtain Board or shareholder approval by special or ordinary resolution as required by the CSE Listing Rules
 - ✓ to document and identify disclosures of Related Party transactions required to be made by the entity on an annual basis, those requiring immediate disclosure and those requiring shareholder approval
- *Maintaining a list of all Related Parties and having a process in place to capture and report any Related Party transactions*
 - *Reviewing and recommending to the Board, of the Related Party disclosures to be made in the Annual Report of the entity.*

For the purpose of evaluating the relevant aspects of the procedures performed by the auditors to achieve the objectives stated in SLAuS 550, SLAASMB inspected a sample of twelve (12) audit engagements carried out by four (4) firms that perform majority of audits of listed entities as depicted in Table 1 below:

Table 1 : Inspection Sample

Firm	Number of audit engagements selected for inspection
Firm A	3
Firm B	3
Firm C	3
Firm D	3
Total	12

3.2 Overview

All entities which were selected for the inspections have established a RPTRC as required by the CSE Listing Rules and have significant Related Parties. All 4 firms have considered the risk of material misstatements associated with Related Party relationships and transactions when identifying and assessing the risk of material misstatements in the areas of understanding the entity and its environment (SLAuS 315 (revised)), the auditors response to assessed risk (SLAuS 330), and the auditors responsibilities relating to fraud in an audit of financial statements (SLAuS 240).

The 12 audit engagements inspected representing 4 audit firms, had performed various substantive audit procedures to identify Related Party relationships and transactions along with different extent of documentation maintained for that purpose. Further, it was noted that the auditors have concluded their risk assessment considering the material misstatements that could lead to non-disclosure of Related Party transactions as per LKAS 24 and other regulatory frameworks.

Auditors can emphasize on the importance of having a sound system/ procedure to identify Related Party relationships and transactions in an entity to ensure that the entity meets the CSE regulations, to ensure the interests of the shareholders as a whole, are taken into account when entering into Related Party transactions and to prevent Directors, Key Management Personnel (KMP) or substantial shareholders, taking advantage of their positions.

On the other hand, the auditors need to evaluate the effectiveness of firm's policies and procedures, which were in effect to meet the requirements of SLAuS 550. Continuous improvements to such policies and procedures, and applying them to all the audit engagements, will uplift the audit quality of the country.

This report has identified the areas where firms can make improvements to their procedures

and to the improvements in application of these procedures in practice, based on the observations made during the thematic audit inspections.

The principal findings observed from the inspection of audit engagements are explained in Section 4.

4. Principal findings from inspection of audit engagements

The audit of Related Party relationships and transactions presents certain challenges to the auditors. Related Party relationships and transactions are not always easy to identify with complex group structures and transactions coupled with absence of effective internal controls in place in entities to identify, record and to document creates challenges to auditors.

Based on the requirements and guidance provided in SLAuS 550, in order to fulfill the responsibility of the auditor as stated in the said standard, the detailed principal findings have been set out under following areas:

- 4.1 Planning the audit of Related Party relationships and transactions.
- 4.2 Understanding the controls relating to identifying Related Parties and recording and summarizing Related Party transactions and outstanding balances.
- 4.3 Performance of Audit Procedures.

Responsibilities of the Auditor

..... Where the applicable financial reporting framework establishes such requirements, the auditor has a responsibility to perform audit procedures to identify, assess and respond to the risks of material misstatement arising from the entity's failure to appropriately account for or disclose related party relationships, transactions or balances

in accordance with the requirements of the framework.

(SLAuS 550, P 3)

4.1 Planning the audit of Related Party relationships and transactions

Irrespective of the size whether large or small, Related Parties exist in all entities. Related Party relationships are a normal feature of commerce and business. For example, entities frequently carry on parts of their activities through subsidiaries, joint ventures and associates.

Related Parties may at times enter into transactions that unrelated parties would not. For example, an entity that sells goods to its parent at cost might not sell on those terms to another customer. Accordingly, a Related Party relationship could have an effect on the profit or loss and financial position of an entity.

The profit or loss and financial position of an entity may be affected by mere existence of a Related Party relationship. For example, an entity may terminate business relations with a trading partner on the entity being acquired by another entity, whose related entity is engaged in the same activity as the former trading partner.

Thus, the auditor must take steps to identify, and to assess the risk of material misstatements arising from the existence of Related Party relationships and transactions, irrespective of whether the

applicable financial reporting framework establishes Related Party requirements.

In order to assess the associated risk, the auditor needs to obtain an understanding of the Related Party relationships and transactions. This understanding will help the auditor to assess any resulting fraud risk indicators, and to conclude on the appropriateness of the accounting treatment and disclosures applied to Related Parties and transactions.

The definition provided for a Related Party in accordance with the applicable SLAuS 550 is as follows:

Related party

A party that is either:

- (i) A related party as defined in the applicable financial reporting framework; or
- (ii) Where the applicable financial reporting framework establishes 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:
 - i. Common controlling ownership;
 - ii. Owners who are close family members; or
 - iii. Common key management.

However, entities that are under common control by a state (that is, 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.

(SLAuS 550, P 10(b))

Similar definition provided for a Related Party as per the applicable Accounting Standard LKAS 24 is as follows:

A related party is a person or entity that is related to the entity that is preparing its financial statements (in this Standard referred to as the 'reporting entity').

- (a) A person or a close member of that person's family is related to a reporting entity if that person:
 - (i) has control or joint control of the reporting entity;
 - (ii) has significant influence over the reporting entity; or
 - (iii) is a member of the key management personnel of the reporting entity or of a parent of the reporting entity.
- (b) An entity is related to a reporting entity if any of the following conditions applies:
 - (i) The entity and the reporting entity are members of the same group (which means that each parent, subsidiary and fellow subsidiary is related to the other).
 - (ii) One entity is an associate or joint venture of the other entity (or an associate or joint venture of a member of a group of which the other entity is a member).
 - (iii) Both entities are joint ventures of the same third party.
 - (iv) One entity is a joint venture of a third entity and the other entity is an associate of the third entity.
 - (v) The entity is a post-employment benefit plan for the benefit of employees of either the reporting entity or an entity related to the reporting entity. If the reporting entity is itself such a plan, the sponsoring employers are also related to the reporting entity.

(vi) The entity is controlled or jointly controlled by a person identified in (a).

(vii) A person identified in (a)(i) has significant influence over the entity or is a member of the key management personnel of the entity (or of a parent of the entity)

(viii) The entity, or any member of a group of which it is a part, provides key management personnel services to the reporting entity or to the parent of the reporting entity.

A related party transaction is a transfer of resources, services or obligations between a reporting entity and a related party, regardless of whether a price is charged. Close members of the family of a person are those family members who may be expected to influence, or be influenced by, that person in their dealings with the entity and include:

- (a) that person's children and spouse or domestic partner;
- (b) children of that person's spouse or domestic partner; and
- (c) dependents of that person or that person's spouse or domestic partner.

(LKAS 24, P 9)

SLAuS 550, highlights the importance of maintaining professional skepticism when planning and performing audit procedures on Related Parties.

In general, to obtain an understanding of the entity's Related Party relationships and transactions, at the planning stage, the auditor could use the discussions at engagement team level. At this discussion, the auditor should emphasize on the susceptibility of the financial statements to material misstatements resulting from Related Parties and transactions, to the audit team.

Accordingly, auditor can discuss the entity's organizational structure, instances of off balance sheet finance, and the existence of any special

purpose entities controlled or influenced by management and information gathered through prior year experience on Related Party relationships and transactions and share known information with the engagement team.

All 12 engagements carried out by the 4 firms have used information in the previous audit working papers relating to Related Party identification and Related Party transactions and have obtained a list of Related Parties for the current year from the entity itself. In most cases the Auditor has reviewed the list obtained from the entity for its completeness, based on the auditor's business understanding and evidence gathered through other audit procedures. In one engagement of Firm A, the auditor has obtained a list of Related Parties from the entity as well as from the Auditor of entity's parent.

All firms except one engagement conducted by Firm C have discussed about the Related Parties at the initial planning meeting discussion had with the engagement team members. In the said engagement, Firm C has not discussed the impact/ importance of existence of Related Party relationships and transactions whereas the risk assessment made by the auditor in relation to Related Parties and Related Party transactions were not documented in the risk assessment matrix.

When evaluating the documentation relating to the planning discussions among the engagement team, an audit engagement carried out by Firm A, comprised of comprehensive documentation relating to all aspects discussed in the meeting, including on how the entity may engage in fraudulent financial reporting, communication with other component auditor, and on impact of significant unusual transactions etc .

Further, in one engagement conducted by Firm B, the engagement partner has emphasized on the importance of being alert on existence of new Related Party relationships and transactions throughout the audit engagement mainly due to a group restructuring process. This has been

discussed in-depth with the engagement team by educating the new group structure and changes made due to the restructuring process.

In another engagement carried out by Firm B, the engagement partner has been changed and in order to share the knowledge gathered from the previous audit, the Director in-charge of the previous audit has been appointed as a member of the current audit engagement team.

Identifying the risk of material misstatements that might arise from Related Party relationships and transactions is an essential aspect of planning, the audit of Related Party relationships and transactions.

SLAuS 550 requires auditors to remain alert for Related Party information that management has not previously identified or disclosed. Thus, understanding the nature of the business, trading partners, normal terms and conditions of the business transactions etc., are crucial for an auditor to be vigilant in detecting previously un-identified and/or undisclosed Related Party information by the management.

During the audit, the auditor shall remain alert, when inspecting records or documents, for arrangements or other information that may indicate the existence of Related Party relationships or transactions that management has not previously identified or disclosed to the auditor.

(SLAuS 550, P 15)

Further, auditor's prior experience with the entity and discussions carried out with other members in the same Firm who have provided non-audit services to the entity, helps to determine whether management has disclosed all relevant Related Party relationships and transactions.

If the auditor identifies the existence of undisclosed Related Parties by the management through further investigations, the auditor should reconsider their risk assessment and amendments

need to be made to their audit procedures accordingly.

All 4 Firms have assessed the risk of material misstatements in relation to Related Party relationships and transactions mainly based on volume of transactions conducted with the Related Parties. However, in two audit engagements carried out by Firm C, the risk assessment did not specify the level of assessed risk in relation to the Related Party relationships/ transactions and disclosures.

All Firms have conducted discussions with management while using a check list to identify fraud risk indicators when assessing the risks of material misstatements associated with Related Party relationships and transactions. However, one of the audit engagements conducted by Firm C has performed an additional audit procedure to check the filings made by the entity at the CSE and has checked the list of shareholdings to identify fraud risk factors associated with Related Parties who have dominant influence.

However, none of the Firms have considered obtaining information from other divisions of the same Firm, who had provided other non - audit services to the entity.

4.2 Understanding the controls relating to identifying Related Parties and recording and summarizing Related Party transactions and outstanding balances

SLAuS 550, requires the auditor to inquire from the management and others within the entity, and perform other risk assessment procedures as appropriate, to obtain an understanding of the controls, if any, that management has established to:

- (a) identify, account for and disclose Related Party relationships and transactions
- (b) authorize and approve significant Related Party transactions and arrangements

- (c) authorize and approve significant transactions and arrangements outside the normal course of business

- ✓ Any known transactions that they have missed out in disclosing
- ✓ Any transactions with Related Parties that have unclear or undocumented terms and conditions

Firm D, has had discussions with Deputy General Manager (DGM) - Finance, Finance Manager and Financial Accountant on Related Parties and Related Party transactions of the entity. However, one engagement of the said Firm has limited the discussion to the requirements relating to the disclosures required as per LKAS 24.

In the above two engagements, even though the auditor has not relied on the work performed by the internal auditor, they have checked the internal auditor's report for the identified issues relating to Related Parties.

In an engagement carried out by Firm A, the auditor has had an effective discussion with the Manager – Finance and Reporting and the Accountant. Further in another engagement Firm A has had discussions with the entity's purchasing team including Manager in-charge of Imports and Head of Internal Controls. In these instances Firm A has inquired from the said personnel on many areas. For example:

The size and nature of the entity has an impact on selecting the correct person to be inquired in order to understand the controls over Related Party and Related Party transactions. More general questions needs to be addressed to non - managerial personnel in order for the discussion to be effective. All the Firms are using general questionnaires regardless of the nature of the entity, size and the person whom to inquire from.

• **To understand Fraud risk**

- ✓ Communication to employees regarding managements' views on business practices and ethical behaviour
- ✓ Controls to prevent, detect and mitigate fraud
- ✓ Actual and suspected or alleged instances of fraud
- ✓ Monitoring operational locations where fraudulent activities had occurred or have a high risk of fraud
- ✓ Instances of management over-ride of control

In all 12 engagements conducted by all 4 Firms, auditors have had discussions with the Audit Committees in the capacity of Those Charged with Governance (TCWG).

However, documenting the adequacy of the inquiries/discussions addressed to obtain an understanding of the entity's controls over Related Party relationships and transactions were evident only in all engagements of Firm B and Firm C. The said information was available only in one engagement out of three engagements of Firm A and Firm D.

• **To understand controls over Related Party and Related Party transactions**

- ✓ Who are the known Related Parties, changes in Related Parties from last year, nature of the business transactions

None of the Firms have considered conducting the discussions with/ inquiring from the members of the Related Party Transactions Review Committees, even when the said Committee members were different from the members of the Audit Committee.

Auditors need to be cautious when discussing about Related Parties with the entity, since it is often considered to be a sensitive matter. Thereby

the auditors need to be attentive when they raise questions in relation to undisclosed Related Party relationships and transactions such as transactions which are not at arm's length, and transactions where business rational is ambiguous etc.

In an engagement of Firm B, the auditor has considered the following factors in order to obtain an understanding of the control environment of the entity's Related Party relationships and transactions. These factors were considered during the discussions had with the management and others within the entity.

- Integrity, ethical values and behaviour of key executives of the entity
- Operating style of the management and their control consciousness
- Participation in governance and oversight by TCWG
- Organization structure and assignment of authority and responsibilities
- Human resource policies and practices.

4.3 Performance of Audit Procedures

In forming an opinion on the financial statements in accordance with SLAuS 700 (Revised), the auditor shall evaluate the accounting for and disclosure of identified Related Party relationships and transactions:

- a) Whether the identified Related Party relationships and transactions have been appropriately accounted for and disclosed in accordance with the applicable financial reporting framework; (i.e LKAS 24) and
- b) Whether the effects of the Related Party relationships and transactions:
 - (i) Prevent the financial statements from achieving fair presentation (for fair presentation frameworks); or
 - (ii) Cause the financial statements to be misleading (for compliance frameworks).

In the selected sample of the entities, it was observed that none of the entities have had a policy to identify and capture Related Parties except for updating a list of identified Related Party transactions by management and reconciling the Related Party transaction balances periodically.

Thereby, auditors have used substantive audit procedures to obtain sufficient appropriate audit evidence in relation to identification of Related Party relationships and Related Party transactions and disclosure of the same. Accordingly, audit procedures such as inspecting documentation, obtaining third party confirmations, reports of the internal auditors, entity's tax return etc., were used by the auditors.

All 4 Firms have obtained written representations from the management (i.e as a Letter of Representation) for all 12 engagements as required by SLAuS 550 since LKAS 24 is the applicable financial reporting framework which establishes Related Party requirements in Sri Lanka.

Where the applicable financial reporting framework establishes related party requirements, the auditor shall obtain written representations from management and, where appropriate, those charged with governance that: (Ref: Para. A48 –A49)

- a) They have disclosed to the auditor the identity of the entity's related parties and all the related party relationships and transactions of which they are aware; and
- b) They have appropriately accounted for and disclosed such relationships and transactions in accordance with the requirements of the framework.

(SLAuS 550, P 26)

LKAS 24 requires the identification and disclosure of information regarding the Related Party relationships and Related Party transactions to be made as such information is expected to be readily available with the management. In most of

the engagements of the 4 Firms, it was observed that general ledger is maintained in the name of the Related Party and a personnel is assigned to summarize the transactions. Commonly it was observed that the Accountant is given the responsibility to summarize Related Party transactions and the Head of Finance reviews such transactions before submitting to the RPTRC.

In an engagement of Firm A, it was noted that KMP and their close family members are identified bi-annually by the entity's Secretary and entity's data collection system is updated accordingly. Such information is shared with the Finance Director who is considered to be the focal point for identifying the Related Parties and Related Party transactions.

None of the audit Firms have used the work performed by the internal auditors in relation to identifying Related Parties and Related Party transactions. However, in two engagements of Firm A, auditor has perused the reports of the internal auditor to obtain information about any Related Party relationships and transactions that management has not previously identified or disclosed to auditor.

During the audit, the auditor shall remain alert, when inspecting records or documents, for arrangements or other information that may indicate the existence of related party relationships or transactions that management has not previously identified or disclosed to the auditor. (Ref: Para. A22 – A23)

In particular, the auditor shall inspect the following for indications of the existence of related party relationships or transactions that management has not previously identified or disclosed to the auditor:

- (a) Bank and legal confirmations obtained as part of the auditor's procedures;**
- (b) Minutes of meetings of shareholders and of those charged with governance; and**

(c) Such other records or documents as the auditor considers necessary in the circumstances of the entity.

(SLAuS 550, P 15)

All 4 Firms have checked the Shareholder registers to identify the entity's principal shareholders. In order to obtain evidence and to remain alert on existence of Related Party relationships and Related Party transactions through KMP, Firms A and B have obtained declarations through entity's Secretary to ensure all interest held by Boards of Directors/ KMP and close family members are identified by the entity as Related Party relationships and Related Party transactions as required by LKAS 24.

However, Firm D has primarily relied on the Letter of Representation given by the entity in all its engagements. In one of its engagements the auditor has checked the payroll to ensure the accuracy of the disclosures made in relation to short term benefits for KMPs.

All engagements of Firm B and one engagement of Firm C has used journal entry testing to identify Related Party transactions by using attributes such as name of identified Related Party, major shareholders etc., when performing journal entry testing. All other firms have used journal entry testing mainly focusing on fraud risk.

5. Good Practices

The audit procedures performed by auditors on Related Party relationships and transactions varies from firm to firm.

Based on the principal findings discussed in Section 4 of this report, SLAASMB identified the following good audit procedures performed by the auditors.

- Discussing at the initial planning meeting with the engagement team about the importance of identifying the Related Parties and the impact of the existence of Related Parties that could effect the performance of the entity and financial position of an entity.
- When engagement partner and the engagement team has been changed,

continuing one senior member as a member of the new engagement team in order to share the knowledge gathered from previous audit.

- Educating the team members on any change to group structure at the initial planning itself.
- Obtaining a list of Related Parties and transactions entered into during the financial year under consideration and obtaining the same from the auditor of the entity's parent.
- Conducting discussions with management to get an understanding on the fraud risk and controls over Related Parties and Related Party transactions.

6. Conclusion

Findings from the thematic audit inspections carried out by SLAASMB, revealed that the auditors have gathered sufficient appropriate audit evidence to form their audit opinion in relation to Related Party disclosures made in the financial statements by the entities. However, the work carried out by the auditors reflected the possibility of improving the audit procedures further.

Auditors can take remedial actions for any common weaknesses mentioned in this report in their future audits. In general, auditors focus more on identified Related Party relationships and Related Party transactions by the management rather than focusing on any un-identified Related Party and Related Party transactions by the management.

However, as fraud risks relating to undisclosed Related Party transactions are crucial for auditors, they should be alert of the possibilities of existence of undisclosed Related Party relationships and transactions and plan their work accordingly.

Further, auditors should adopt an effective two - way communication with the members of Related Party Transactions Review Committee rather than merely reviewing the meeting minutes of the Committee. The interaction of the auditors with the RPTR Committee will ultimately result in improving the process of identifying the Related Party relationships and the Related Party transactions of the entity.

