Related-party transactions draw attention from auditors

Related-party transactions and financial connections are a normal part of operating a business. But these arrangements have gotten a bad rap because dishonest people sometimes use them to disguise poor performance or dishonest activities. So, identifying related parties and evaluating your interactions with them are important parts of the external audit process — especially in today's volatile market conditions.

Accounting definition

In an accounting context, the term "related parties" refers to "any party that controls or can significantly influence the management or operating policies of the company to the extent that the company may be prevented from fully pursuing its own interests." Examples of related parties include:

- Affiliates and subsidiaries,
- Investees accounted for by the equity method,
- Trusts for the benefit of employees,
- Principal owners, officers, directors and managers, and
- Immediate family members of owners, directors or managers.

Focal points

The auditing standards on related parties target three critical areas:

1. Related-party transactions,
2. Significant unusual transactions that are outside the company's normal course of business or that otherwise appear to be unusual due to their timing, size or nature, and
3. Other financial relationships with the company's owners, directors, officers and managers.

Auditors strive for an in-depth understanding of every related-party financial relationship and transaction, including their nature, terms and business purpose (or lack thereof). Examples of information that may be gathered during the audit that could reveal undisclosed related parties include information contained on a company's website, tax filings, corporate life insurance policies, contracts and organizational charts.

Certain types of questionable transactions — such as contracts for below-market goods or services, bill-and-hold arrangements, uncollateralized loans and subsequent repurchase of goods sold — also might signal that a company is engaged in unusual or undisclosed related-party transactions.

Eye on compensation

Executive compensation is a key example of a related-party arrangement that's subject to heightened scrutiny from auditors. Executives can potentially influence financial reporting and may feel incentives or pressures to meet financial targets. The auditing standards require in-depth inquiry about executive compensation, including performance-based bonuses and stock options.

Auditors also test the accuracy and completeness of management's reporting for and disclosures of these transactions. But they're *not* required to make any recommendations or determinations regarding the reasonableness of compensation arrangements.

Full transparency

Investors, lenders and other stakeholders appreciate companies that present related-party relationships and transactions, openly and completely. You can help facilitate the audit process by being up-front with your auditors about all related-party transactions, even if you don't think they're required to be disclosed or consolidated on the company's financial statements. Contact us for more information about transactions and financial connections that may fall under the related-party accounting rules.

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