THE RELATED PARTIES –APPROACHES TO LEGAL, ACCOUNTING, TAX AND AUDIT IMPLICATIONS

PĂRŢILE AFILIATE – ABORDĂRI LEGALE, CONTABILE, FISCALE ŞI IMPLICAŢII ÎN AUDIT

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Abstract: *Transactions with related parties represent a concern to profesional accountants and management of economical entities. Because of the impact, sometimes severe, that they can generate to financial situations made by related parties, the control and management procedures of appropriate audit evidence about this type of transaction has a specific special. Professional standards in identifying and examining related parties transactions and by default transfer pricing is decisive, with a risk that some transactions to conceal fraudes or significant errors.*

Key words: *resource transfer, related parties, transactions, statements, audit.*

INTRODUCTION

According to accounting rules **related parties** are represented by those parties who jointly control the entity, joint ventures where the entity is an associate and post-employment benefit plans in the benefit of the employees of an entity, or any entity which is a related party of this entity.

The parties are considered related if one of the parties has the ability to control, partly to control or to exercise a significant influence over other party.

MATERIALS AND METHODS

Our approach has as an objective a clarifying of the importance and the necessity of correct applying the accounting principles for elaborating financial statements, disclosure of transactions with related.

The research will focus on the systematization and the integration of the notions from the regulations elaborated by the state's authorities.

For the research we have used a deductive and inductive method for identifying the opinions, the critics and the opportunities. In the first part we have done a comparative analysis of the legal and financial-accounting regulations. For a profound research we have identified, based on the situations met in practice, the problems that have appeared in the financial-accounting departments' activities and we have formulated solutions for a correct application of the accounting regulations.

1. Aspects from accounting

International accounting rules: IAS 24 - disclosure of related parties and IAS 28 Investments in Associates.

The IAS 24 objective is to provide the required information when the financial position or performance can be affected by the existence of related parties and of transactions with them.

IAS 24 contains provisions relating to the identification of related parties, of transactions with them and of the resulting balances, the circumstances which requires disclosure in financial statements.

In the absence of information on related party transactions, financial statement users may conclude that the company acted independently in their own interest and all transactions have been concluded under normal conditions and at fair value.

Performance and financial position of an enterprise may be affected even if there were no related party transactions. For example, a subsidiary may terminate relations with a trading partner because that is purchased by a parent company, its decisions are influenced by the instructions given to it.

According to IAS 24, a transaction between related parties represents a transfer of resources, services or obligations whether or not a cost.

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In February 2007 the IASB published a survey statement, amendments to IAS 24. The project proposes to redefine and reduce related party information requirements for entities over which the State exercises control or significant influence. Amending the definition of related party is centered on four issues.

The first concerns the relationship between an associate and a subsidiary. Under IAS 24, transactions between the two are to be published only in the financial statements of associated and not those of the subsidiary. IASB proposes to complete the definition so that a subsidiary and an associated company of the same mother are considered related parties in their individual financial situations.

The project examines the relationship between two associated companies of the investor. According to IAS 24, if an investor exercises significant influence over an associate company and a close member of his family exert significant influence over another entity, the two are considered related. But if the investor is an entity apply the earlier rule. IASB proposes that companies to which a person exerts a significant and that a member of its family are considered related parties to each other.

Under IAS 24 an entity that has the key investor manager of another company does not consider the latter part related to each other is valid though. The project proposes a symmetrical treatment.

According to the statement, survey, part of the reporting entity can be linked to a person or entity that is related to the entity preparing financial statements (reporting entity).

International Accounting Standard IAS 28 Investments in associates are applied in accounting for investments in associates.

IAS 28 prescribes the accounting treatment of investments in associates, other than shares held by investment funds, mutual funds and similar entities (these shares are valued at fair value with changes reflected in the profit and loss under IAS 39).

Significant influence (notable) is the power to participate in decisions on financial and operating policies of the associated company, without controlling these policies. As control, what matters is rather the right to participate or influence than the actual exercise of power. For

example, an investor does not need to exercise their rights if the investee company does what it wants, either by chance or due to a schedule.

National accounting rules: O.M.F.P. 3055.2009 for aproving the Accounting rules harmonized with European directives

That legislation takes the ideas presented in international standards that we mentioned in Chapter 2 relating to the consolidated financial statements of a group of entities.

2. Tax issues

For tax purposes, the definition of related parties is given by the Fiscal Code. According to art. 7 (Definitions of common terms), paragraph 21:

"A person is affiliated with another person if the relationship between them is defined by at least one of the following cases:

a) an individual is affiliated with another person, if they are husband / wife or relatives to the third degree inclusive. Between affiliates, the price at which transfer of tangible or intangible, or services are provided is the transfer price;

b) an individual is related with a legal entity owns, directly or indirectly, including holdings of affiliated persons, at least 25% of the value / number of shares or voting rights owned the legal person or if it controls effectively the legal person;

c) a legal entity is affiliated with other entity if at least:

i)the first minimum 25% legal entity owns, directly or indirectly ncluding holdings of affiliated persons, of the value / number of shares or voting rights or other legal entity that controls the legal person;

ii) the second person owns, directly or indirectly, including holdings of affiliated persons, at least 25% of the value / number of shares or voting rights in the first person;

(iii) a third person holds, directly or indirectly, including holdings of affiliated persons, at least 25% of the value / number of shares or voting rights as the first person and in the second.

The market pricing of transactions between related parties are using the most appropriate of the following methods:

- Method of comparing price (CUP or CPN)
- A cost-plus (C +)

- Resale price method (R-)

- Any other method recognized in transfer pricing guidelines issued by the Organization for Economic Cooperation and Development. (eg net margin method and profit sharing method).

In general, when determining the market price of services in transactions between related parties, tax authorities first examine whether independent people, with good behavior, such a transaction would be completed as determined by the affiliates.

Fiscal Procedure Code

According to the Fiscal Procedure Code "To determine the actual fiscal situation and tax obligations owed, taxpayers are required to conduct fiscal records according to laws in force. To determine transfer prices, **taxpayers engaged in transactions with related parties have the obligation to request the competent fiscal body to prepare and present it in due time, file transfer pricing** ".

Order A.N.A.F. no. 222/2008 - the contents of the file transfer pricing

According to Order A.N.A.F. no. 222/2008, to establish transfer prices, taxpayers engaged in transactions with related parties have the obligation to request the competent fiscal body to prepare and present it in due time, file transfer prices.

Regarding the contents of the file transfer pricing documentation is taken into account:

- Detailed description of business and business strategy, changes in business strategy from the previous year;

- Description and explanation of specific controlled transactions;

- Comparative analysis (characteristics of property and services, functional analysis, contractual terms, economic circumstances and specific business strategies),

- Explain the method (s) selected for transfer pricing;

- Relevant information on domestic prices and / or comparable foreign;

- Description of the application of transfer pricing policy within the group.

Because of the recession, many multinational groups have begun to document the transfer pricing strategy carefully because authorities around

the world are trying to stabilize tax revenues decrease, and controls on transfer pricing documentation became more aggressive.

Changes in economic climate may force changes in business model adopted by multinational groups and to transfer pricing model under stress. Many of transfer pricing systems were not designed to cope with rapid changes in the economy because these systems require stable conditions of profitability, revenues and expenses. Consequently, current systems transfer pricing can have implausible results, such as extreme profits and losses of certain entities of the group for most.

Implications for audit

The International Standard of Audit (ISA) no. 550 estabilishes the fundamental procedures and principles, and how to apply them to the auditor's responsibilities relating to transactions between related parties (affiliates), as defined by **International Accounting Standard IAS 24 - disclosure of related parties.**

ISA 550 Related parties estabilishes standards and provides gudiance on the responsibilities of auditors and audit procedures regarding related parties and transactions with such parties.

The related party transaction means a transfer of resources or obligations between related parties, whether or not a price is charged, including transactions between the parties voluntarily and knowingly placed.

In order to obtain relevant information for identifying risks of material misstatement associated with related party relationships and transactions, the auditor must perform audit procedures, such as interviewing management and other individuals in the entity, in understanding the checks carried out to identify, explain and present relationships and related party transactions, to authorize and approve significant transactions and related party agreements, inspection or legal confirmations obtained from banks as part of the auditor's procedures, the minutes of meetings and CA AGM and any other records or documents which the auditor considers necessary in the circumstances of the entity.

The auditor should communicate with those charged by the Government of significant matters arising during the audit in relation to related party entity.

To understand the entity's internal control, the auditor will consider the adequacy of control activities over the authorization and recording of transactions with related parties.

During the audit, the auditor must be alert for transactions which appear unusual in the circumstances and may indicate the existence of previously unidentified related parties. Examples include the following:

- Transactions which have abnormal terms such as prices, interest rates, collateral and repayment terms unusual.
- Transactions which lack a business logic motivation to occur.
- Transactions in which substance differs from form.
- Transactions processed in an unusual manner.
- Important transactions or of a large volum carried out with clients or suppliers as compared to others.
- Unrecorded transactions such as receiving or providing management services not invoiced and uncollected.

During the audit, the auditor will use the audit procedures which can identify the existence of transactions with related parties. For example:

- Performing of detailed test of transactions and balances.

Reviewing minutes of meetings of shareholders and those charged with governance.

- Review records in terms of large or unusual transactions or balances, paying particular attention to transactions recognized at or near the end of the reporting period this time.
- Reviewing confirmations of loans receivable and payable and confirmations from banks. Such a review may indicate guarantor relationship and other related party transactions.
- Reviewing investment transactions, for example, purchase or sale of shares in an equity joint venture or another entity.

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In examining the identified related party transactions, the auditor should obtain sufficient appropriate audit evidence to prove whether these transactions were properly recorded and disclosed.

Given the nature of related party relationships, audit evidence about the existence of related party transactions may be limited, for example, in

the existence of inventory held on consignment by a related party or an instruction from a parent company to a subsidiary to record a royalty expense.

CONCLUSIONS

Standard ISA **550 - Related Parties** requires that auditors have sufficient understanding of the entity and its environment that would allow identification of the events, transactions and practices that can lead to the risk of material misstatement regarding related parties and transactions with such parties.

The existence of related parties – the group as whole – and transactions between such parties are considered ordinary features of business, the **auditor should be aware of their existence, to**:

- To recognize fraud risk factors, where applicable, appearing in the relations and transactions with related parties that are relevant to identifying and assessing risks of material misstatement due to fraud and

- Draw conclusions based on audit evidence obtained, whether the financial statements to the extent they were affected by those relationships and transactions acquire fair presentation (for fair presentation frameworks) or misleading (for compliance frameworks).

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2.*** OMFP No. 3055/2009 for approving the accounting regulations according to the European directives.

3.*** IAS 24 - disclosure of related parties

4.*** IAS 28 Investments in Associates.

5.*** ISA 550 - Related Parties

6.*** Fiscal Code of Romania. Law No. 571/2003

7.***Fiscal Procedure Code Government. Ordinance no. 92/ 2003

8.***Order A.N.A.F. no. 222/2008 about the contents of the file transfer pricing