



The Impact of Transfer Pricing on the Company's Image.

Implications in Audit Work

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Abstract

In an economy strongly marked by globalisation, transfer pricing is at the top of the agenda of taxpayers, tax authorities and regulatory bodies, with its influence manifested primarily in the fiscal area, respectively in the correct determination and proper allocation of the corporate tax base between different jurisdictions or between companies operating within the same jurisdiction. However, transfer pricing transcends the fiscal problematic and significantly influences other aspects of a company's life, one of which is the image reflected in the annual financial statements, including cash flows or financial performance indicators, and through their analysis, the investment decisions of potential users of accounting information.

Transfer pricing is, therefore, also a reference point in the audit work carried out at the level of companies part of national or multinational groups and involved in significant intra-group transactions, as compliance or non-compliance with the arm's length principle directly influences the way in which different elements of income, expenses, results, assets, equity or liabilities are reflected or not in accordance with the true and fair view principle and thus, ultimately, the audit opinion. National and international auditing standards provide recommendations and guidance on how to deal with transfer pricing issues as part of audit engagements, reflecting a continuing concern by professional bodies to develop best practices in this area.

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By studying the legislation in force and the available literature as well as by analysing (over a 5 year timeframe, i.e. 2018 - 2022) the information included in the annual financial statements of three companies listed on the Bucharest Stock Exchange, included in the "Constituents index - BET" category, which are part of a group and are involved in transactions with related parties, the objective of this article was to identify the main elements to be considered and analysed in the audit work with regard to transfer pricing. Following the research carried out, it can be concluded that, in accordance with the recommendations and requirements of national and international auditing standards, in the context of audit engagements carried out for companies involved in transactions with related parties, transfer pricing is one of the elements that should be subject to recurrent analysis as its impact on the result of the financial year but also on other elements included in the financial statements (e.g. payables, receivables, etc.) can be significant, directly influencing the true and fair view that they should reflect.

Key words: transfer pricing; groups of companies; audit; arm's length principle; true and fair view principle;

JEL Classification: K34, M41, M42, M48

Introduction

Transfer pricing is a concept applicable in the field of taxation, representing the prices at which goods and services are traded between related parties (the clearest example of related parties being companies belonging to multinational or local groups).

The entire transfer pricing problematic has experienced a significant development during the last 30 years, alongside the increasing trend towards globalisation and the significant growth of world trade, at which time tax authorities have also turned their attention towards the need to create an appropriate regulatory framework that allows the fair distribution of profits earned by multinational groups in the jurisdictions in which they operate. At the same time, prestigious international bodies such as the Organisation for Economic Cooperation and Development (OECD), the European Union (EU), the United Nations (UN) and the World Bank (WB) have set up working groups dedicated to the subject of transfer pricing, recognising the importance of this issue and the need for a systematic and unified strategy and approach for its associated concepts.

According to the OECD report published in May 2018 (based on 2014 data), about half of international imports and exports are generated by multinational companies/groups, and their activity also generates about 28% of global gross domestic product (GDP) and about 23% of global employment¹. The statistics therefore reflect the particular contribution that groups of companies are making to the global economy and, in the fiscal context, the importance of the transfer prices applied in transactions between group companies, given that these transactions are undertaken considering not only the general free market principles (e.g. supply and demand) but also specific aspects such as the group's strategy and internal objectives.

The fiscal problematic associated with transfer pricing is based on the fact that transfer pricing can be used as a tax optimisation mechanism given that it directly influences the taxable income or deductible expenses incurred by a company part of a group. However, transfer pricing transcends the fiscal problematic, generating effects on other economic and financial indicators essential in reflecting the performance of a company such as cash flows, profitability, solvency and liquidity, financial position, etc.

Over time, with the diversification and development of commercial transactions, transfer pricing has become an important discussion point not only in terms of analysing how companies conduct business with each other (both companies in different jurisdictions and companies within the same jurisdiction), but also with individuals with whom they are in an affiliation relationship (e.g. shareholders, directors, etc.). Transfer pricing has therefore become an important and complex topic of discussion today, which certainly needs further research.

On the other hand, as a result of developing awareness on the importance of financial auditing, the interest of the users of accounting information in the quality of the audit has increased considerably. The enhanced awareness is also due to the increasingly frequent and highly publicised cases of bankruptcies / significant difficulties in continuing operations of some very large companies, which managed in one form or another to conceal their aggressive business practices, some of which were based on intra-group transactions, with the intention of distorting the information included in their financial statements and hiding the economic substance of the transactions.

¹ The role of multinational companies in the global economy. Intensely discussed but barely measured, Organisation for Economic Cooperation and Development, 2018, p. 5

In relation to the review of the transactions with entities that are part of the same group, both international and local bodies provide rules designed to standardise and facilitate audit work. However, the auditor often faces challenges in identifying and verifying the related parties of the audited company and the transactions taking place with them. These barriers are based on reasons such as the lack of understanding of the arm's length principle, deficiencies in identifying related parties, communication deficiencies between the auditor and the person appointed by the company to maintain the communication as part to the audit process, deficiencies in internal control etc.

Therefore, in the light of the information presented, we believe that a review of the audit practices used in the verification of related party transactions would be auspicious to facilitate future improvements in audit quality and promote efficiency in audit work.

1. Literature and legislation review

1.1. Basic concepts included in the transfer pricing legislation

The Romanian transfer pricing legislation follows the general principles outlined in the Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations developed by the Organisation for Economic Cooperation and Development ("OECD Guidelines"). In addition, Law No. 227/2015 regarding the Fiscal Code (Fiscal Code) specifically states that, in addition to the local legislation, the provisions of the OECD Guidelines² should be taken into account when conducting transfer pricing analyses. At the same time, the fact that many EU member states are also OECD members means that the European transfer pricing legislation and any other reports produced by European institutions in this area follow the same reasoning.

Therefore, all the important concepts used in Romania in the field of transfer pricing, presented in the following paragraphs, have their origin in the OECD Guidelines (or other similar reports prepared by the OECD to complement and elaborate on the provisions of the guidelines).

Affiliated persons / Related parties

The existence and analysis of transfer prices are generated by the existence of **related parties / affiliated**

persons. In Romania, the definition of affiliated persons can be found in the Fiscal Code, namely in paragraph 26 of Article 7. According to it, we can speak of the existence of an affiliation relationship in any of the following situations: affiliation between two natural persons (based on marriage or kinship - up to and including third degree family relations), affiliation between a natural person and a legal person (on the basis of a direct or indirect ownership of at least 25% of the natural person in the legal person or the existence of control) and affiliation between two legal persons (on the basis of a direct or indirect ownership of at least 25% of one of the legal persons in the other or the exercise of control, or if each of the two legal persons is owned, directly or indirectly, by a third legal person with a participation of at least 25% or are controlled by it).

Conceptually, as a way of exercising affiliation, we have the following situation:

- direct ownership, manifested by the existence of a direct participation of at least 25% by a natural or legal person in another legal person;
- indirect ownership, manifested by the existence of an indirect participation (i.e. meaning the participations in other related parties and by other related parties) of at least 25% held by a natural or legal person in another legal person. Indirect affiliation also defines the situation where two legal persons are considered affiliated if they are owned by a third legal person with at least 25% each;
- exercising control.

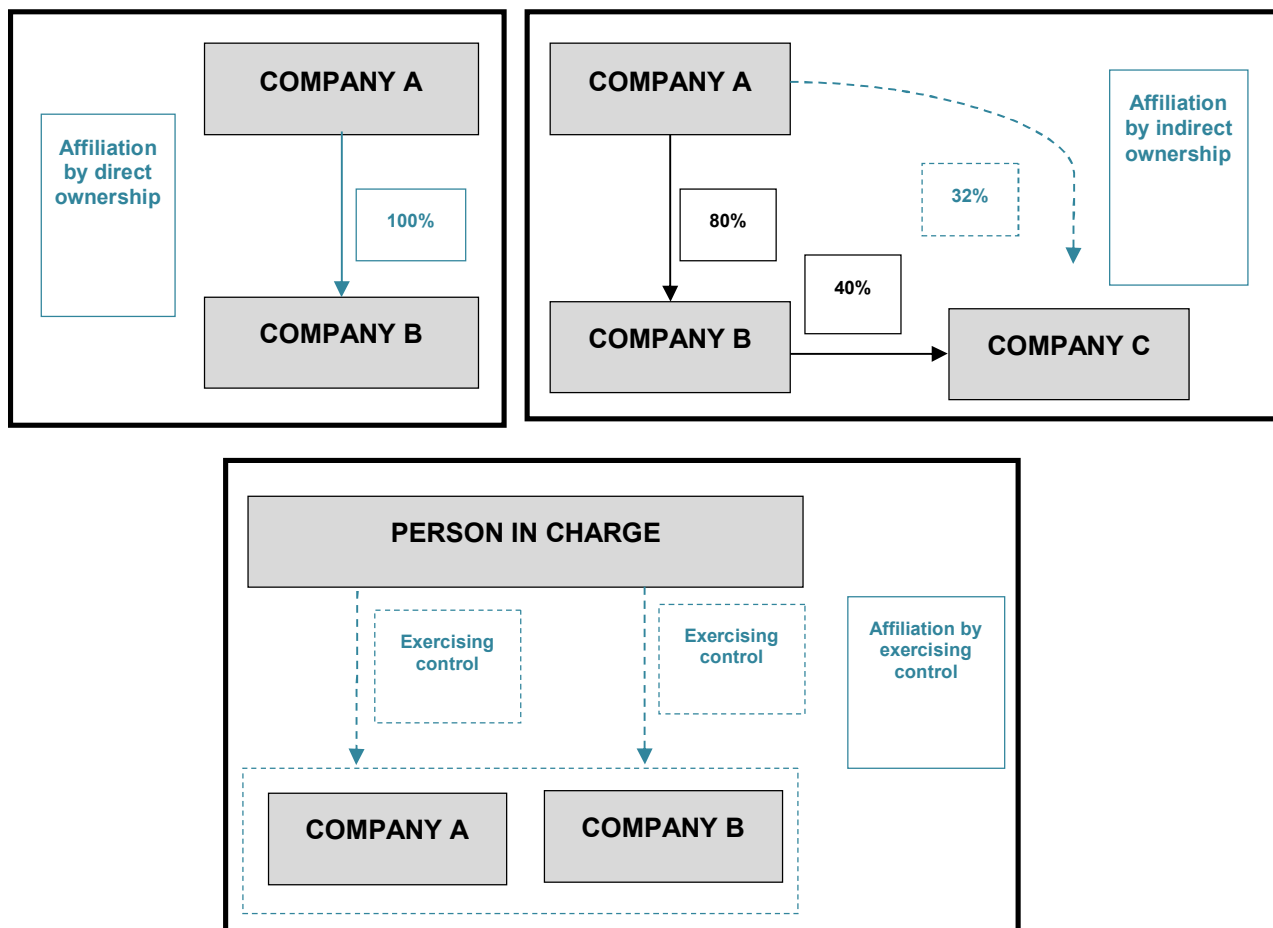
The Clarification of the notion of control is made in H.G. 1/2016 for the approval of the Methodological Norms for the application of Law no. 227/2015 regarding the Fiscal Code ("Methodological Norms"), which states that "[...] a person shall be deemed to effectively control a legal person if it is established that, both factually and legally, [...] the administrator/management personnel has the power to decide on the activity of the concerned legal person, by concluding transactions with other legal persons which are under the control of the same administrator/management personnel, or that the person in charge of the legal person is a shareholder or administrator in the concerned legal person [...]"³.

Figure no. 1 summarises how affiliation relationships can be exercised.

² Law no. 227/2015 on the Fiscal Code, art. 11, point 4

³ H.G. 1/2016 for the approval of the Methodological Norms for the application of Law no. 227/2015 regarding the Fiscal Code, Title I, Chapter 1, Section 2, point (1)

Figure no. 1. Graphical presentation of the ways of exercising membership



Source: Authors' own processing

Arm's length principle

The specific legislation states that transactions between affiliated persons / related parties must comply with the **arm's length principle**. The definition of the arm's length principle is found in the Romanian Fiscal Code and is similar to the definition included in the OECD Guidelines. According to it, "where conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions,

have not so accrued, may be included in the profits of that enterprise and taxed accordingly"⁴.

From a practical point of view, the application of this principle implies that two affiliated persons should undertake transactions in a manner similar to that which would have been applied if the affiliation had not existed. The application of the arm's length principle as the basis for establishing a fair price (for both taxpayers and tax authorities) in transactions between related parties is the most common solution currently used internationally, but not the only one possible. For example, the OECD Guidelines also describe the alternative of using a global

⁴ Law no. 227/2015 on the Fiscal Code, art. 7, item 26

formulary apportionment of a multinational company's global profits, detailing the advantages and disadvantages of this model.

However, the view of OECD member countries (included in the OECD Guidelines) continues to be that the arm's length principle should guide the assessment of the transfer prices applied in transactions between related parties, as it provides the closest approximation of what would have resulted as price (for the sale of goods or the provision of services) if the free market mechanisms were applied⁵. This does not mean that the application of the arm's length principle has no limitations and that sometimes the results of applying this principle may not be counter-intuitive, but only that it represents the best alternative currently available.

The application of the arm's length principle involves selecting a transfer pricing method, conducting a comparability analysis (taking into account the specific comparability factors set out in the OECD Guidelines) and calculating an arm's length range that can be used as benchmark.

Transfer pricing methods

Transfer pricing methods are ways of analysing whether the transfer price applied in a particular category of transactions between related parties complies with the arm's length principle. From a methodological point of view, depending on their specificity, transfer pricing methods are based either on the analysis of the prices charged in the transactions or on the analysis of the profit margins (gross or net) obtained by the parties involved in the transaction.

Similar to the OECD Guidelines, the Fiscal Code makes reference to five transfer pricing methods⁶ that can be used as part of a transfer pricing analysis, recognising also the possibility for taxpayers and tax authorities to use any other method deemed appropriate to the extent that it leads to a better result, as follows: the comparable uncontrolled price method, the cost plus method, the resale price method, the transactional net margin method and the profit split method.

In addition, the Methodological Norms set out the characteristics of each transfer pricing method, including examples of the categories of transactions for which the use of a particular transfer pricing method is appropriate. The OECD Guidelines state that the first three transfer pricing methods (i.e. the comparable uncontrolled price method, the resale price method and the cost-plus method) are classified as traditional methods, while the following two methods (i.e. the profit split method and the transactional net margin method) are transactional methods.

As part of a transfer pricing analysis, the objective is to select the method that best suits the specifics of the case (there is no one method that is conceptually better than the other, and no method that is applicable in all or most cases).

The selection of a particular transfer pricing method should be made taking into account the characteristics of each method, its advantages and limitations, the profile of the parties involved in the transactions (determined as part of a functional analysis), the availability of information as well as the likelihood that the method will provide the best estimate of an arm's length outcome⁷. This is also reflected in the Methodological Norms which state that:

"(4) [...] The following elements shall be taken into account in determining the most appropriate method: (a) the method that most closely approximates the circumstances in which arm's length prices are established in commercially comparable markets; (b) the method for which data is available from the actual operation of related parties involved in arm's length transactions; c) the degree of precision with which adjustments can be made to achieve comparability; d) the circumstances of the individual case; e) the activities actually carried on by the various related parties; f) the method used must be consistent with the taxpayer's particular market and business circumstances; g) the documentation that may be made available by the taxpayer"⁸.

The general framework of application, the particularities and the extent of use of each method are summarised in **Table no. 1**.

⁵ *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, Organisation for Economic Cooperation and Development, 2022, Chapter I, Section B.2*

⁶ *Law no. 227/2015 on the Fiscal Code, art. 11, item 4*

⁷ *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, Organisation for Economic Cooperation and Development, 2022, Chapter II, Part I, A 2.2*

⁸ *H.G. 1/2016 for the approval of the Methodological Norms for the application of Law no. 227/2015 regarding the Fiscal Code, Title I, Chapter 2, Section 2, point (4)*

Table no. 1. Summary of the general applicability of transfer pricing methods, important issues to consider as part of their application and their extent of use in practice

	COMPARABLE UNCONTROLLED PRICE METHOD	COST PLUS METHOD	RESALE PRICE METHOD	PROFIT SPLIT METHOD	TRANSACTIONAL NET MARGIN METHOD
Generally applied for:	Transactions with generic goods Financial transactions Licensing transactions	Transactions with finished goods Provision of services	Transactions with merchandise	Interconnected activities	All categories of activities
Important aspects to consider	Internal comparables External comparables	Internal comparables Cost base Profit mark-up	Internal comparables Selling price to independent parties Gross margin	Contribution analysis Residual profit analysis	Profitability segmentation Access to databases
Extent of use in practice	Average	Very rare (with a gross margin analysis) Average (with a net margin analysis)	Seldom	Very rare	Frequent

Source: Authors' own processing

Comparability analysis

At the heart of the application of the arm's length principle is the **comparability analysis**, which involves comparing a transaction between related parties (referred to as a controlled transaction) with a transaction between independent partners (referred to as a uncontrolled transaction)⁹. In order to comply with the arm's length principle, the basic rule is that a transaction between related parties must take place as it would have if it took place between independent parties.

In order to identify uncontrolled transactions or information regarding uncontrolled transactions, taxpayers, tax authorities or transfer pricing specialists have access to two broad categories of sources:

1. **internal sources** – i.e. information available at the level of one of the related parties involved in the controlled transactions, regarding similar transactions

undertaken with independent partners on the open market. As a rule, information from internal sources is more detailed (as the taxpayer has direct access to all relevant documents and data) and is obtained at a lower cost. Comparable transactions obtained from internal sources are called internal comparables;

2. **external sources** – i.e. information from outside the companies involved in the controlled transactions, relating to similar transactions undertaken between independent partners on the open market. The most common external sources are represented by specific databases used for transfer pricing analysis (e.g. Orbis, RoyaltyStat, etc.) but reports produced by various institutions or consultancy companies in specific fields can also be used. As a rule, information from external sources is not very detailed and is more costly to obtain. Comparable transactions obtained from external sources are called external comparables.

Starting from the presumption that comparability analyses cannot be perfect, it should be noted that they must achieve a number of specific objectives, as follows:

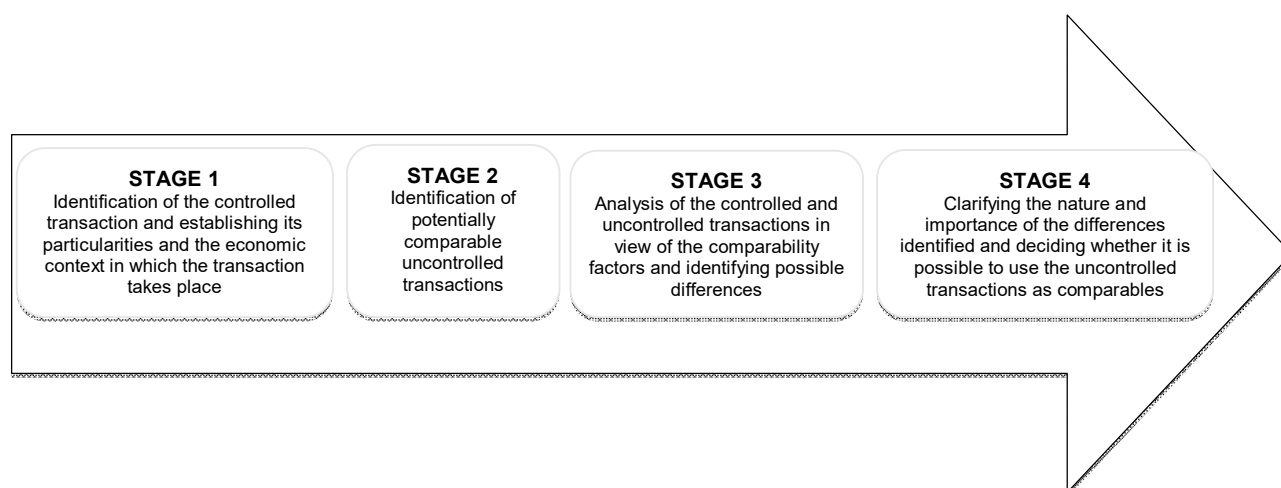
⁹ Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, Organisation for Economic Cooperation and Development, 2022, Chapter III, Section A 3.1

- obtain a full understanding of the controlled transaction, including: (i) the economic context that leads to the transaction, (ii) the contribution of each party to the transaction, i.e. what responsibilities it has, what risks it assumes, what assets it uses (aspects identified by conducting the functional analysis), and (iii) how the transfer price in the transaction was determined;
- identification of the most appropriate uncontrolled transactions that can be used as a reference for the

controlled transaction (for an uncontrolled transaction to be used as a reference there must be no significant differences between it and the controlled transaction or, if there are such differences, comparability adjustments can be made to eliminate these differences).

The process of elaborating a comparability analysis is iterative and requires the exercise of professional judgement. The OECD Guidelines mention 9 steps to be followed in preparing a comparability analysis, which can be grouped into four main stages shown in **Figure no. 2**.

Figure no. 2. Steps to be applied as part of a comparability analysis



Source: authors' own processing

The selection of those uncontrolled transactions that can be used as a comparability benchmark is made by reference to the five comparability factors mentioned in the OECD Guidelines, namely: the characteristics of the goods / services, contractual framework, functional analysis, economic circumstances of the parties and the market and business strategy.

Depending on the transfer pricing method used in the analysis of a particular controlled transaction, the importance of certain comparability factors may be greater or smaller (e.g. if the comparable uncontrolled price method is used, the characteristics of the goods / services play a central role, but the role of this comparability factor is less important if the transactional net margin method is used to analyse the compliance with the arm's length principle). However, the central objective of a

comparability analysis will always be to identify the best available reference at a given point in time.

The compliance with the arm's length principle is most often analysed by reference not to a single value but to a range of value (an arm's length range).

Arm's length range

As a concept, **the arm's length range (the benchmarking range)** is mentioned both in the Fiscal Code and in OP ANAF No. 442/2016 on the conditions surrounding the amounts of transactions, submission of the transfer pricing documentation file, content and conditions of requesting the preparation of the transfer pricing documentation file and application of transfer pricing adjustments / estimation procedure (Order 442/2016). However, a detailed presentation of the

concept, including the important elements to be taken into account in determining the arm's length range, is provided in Order No 442/2016, which states that the market range is in fact the interquartile range, between the lower and the upper quartile¹.

The determination of the arm's length range involves a statistical computation based on information from observations in a final sample, the objective of this calculation being, on one hand, to determine what is the margin/result/price charged on the market by independent companies involved in the same type of transactions as those carried out between related parties and, on the other hand, to determine the central tendency of the market, as a point used by the Romanian tax authorities in performing transfer pricing adjustments or estimates, in those situations where taxpayers cannot adequately prove/document the compliance with the arm's length principle of the transactions undertaken with related parties.

In practice, the arm's range is actually the interquartile range and the central tendency of the market is the median.

1.2. Literature review

As the business environment evolved, companies developed various strategies to optimise their tax burden, which is why financial auditing is one of the key enablers of corporate accountability, its purpose being to provide, in the form of an audit opinion, assurance on audited financial information. Looking at it from the perspective of globalisation, given the expansion of the companies' economic activity into the territories of other countries, their image can be influenced by transfer pricing. This increases the audit risk, which leads auditors to put more effort into the process of auditing financial statements.

According to Wenxia Ge et al (2010)², before new regulations were introduced regarding the disclosure of

related party transactions in the financial statements of companies in the Chinese market, investors used to adjust earnings when valuing a company that engages in related party transactions. In addition, the emergence of new scandals involving transfer pricing companies has raised investors' doubts about the amount and relevance of information provided in the notes to the financial statements. Unlike investors, external auditors have access to detailed information and explanatory documents in their analysis of the transfer pricing system of the audited company. Thus, the importance of the financial audit increases in the eyes of investors, in terms of the need for assurance on the veracity of the financial statements.

Rasheed P. C. et al (2021)³ concluded that there is a direct relationship between the types of transactions conducted between related parties and increased audit risk, resulting in increased auditor fees. Moreover, El-Helaly (2018)⁴ observed that the relationship between intra-group transactions and the quality of earnings presentation is rather negative, and the risks given by the existence of economic relationships between related parties have implications for the auditor's work as their reputation may be affected by exposure to possible litigation. On the other hand, trading with an affiliated party in the same industry has been shown to increase firm performance (H.-D. Wang et al, 2019)⁵.

Internally, the study by Pasc et al (2021)⁶ shows that that the level of compliance of financial reporting follows an increasing trend during the period under review, but as there is not yet a mature law standardising the disclosure of related party

³ Abdul Rasheed, P. C., Iqbal, T. H., & Mallikarjunappa, T. (2021) *Related party transactions and audit risk*. Cogent Business & Management, 8(1)
doi:<https://doi.org/10.1080/23311975.2021.1888669>

⁴ Moataz El-Helaly, Ifigenia Georgiou, Alan D. Lowe (2018), *The interplay between related party transactions and earnings management: The role of audit quality*, Journal of International Accounting, Auditing and Taxation, Volume 32, Pages 47-60, ISSN 1061-9518,
<https://doi.org/10.1016/j.intaccaudtax.2018.07.003>,
(<https://www.sciencedirect.com/science/article/pii/S1061951818301708>)

⁵ Hong-Da Wang, Chia-Ching Cho, Chan-Jane Lin (2019), *Related party transactions, business relatedness, and firm performance*, Journal of Business Research, Volume 101, Pages 411-425, ISSN 0148-2963, <https://doi.org/10.1016/j.jbusres.2019.01.066>, (<https://www.sciencedirect.com/science/article/pii/S0148296319300864>)

⁶ Pasc, L.-V., Hătegan, C.-D., (2021), *Reporting Significant Transactions with Affiliated Parties of Listed Companies on Stock Exchange*, Audit Financiar, vol. XIX, no. 2(162)/2021, pp. 359-372, DOI: 10.20869/AUDITF/2021/162/012

¹ OP ANAF 442/2016 on the conditions surrounding the amounts of transactions, submission of the transfer pricing documentation file, content and conditions of requesting the preparation of the transfer pricing documentation file and application of transfer pricing adjustments / estimation procedure, art. 8

² Wenxia Ge, Donald H. Drury, Steve Fortin, Feng Liu, Desmond Tsang Tsang (2010), *Value relevance of disclosed related party transactions*, Advances in Accounting, Volume 26, Issue 1, Pages 134-141, ISSN 0882-6110,
<https://doi.org/10.1016/j.adiaac.2010.02.004>. (<https://www.sciencedirect.com/science/article/pii/S0882611010000076>)

transactions in financial statements, it could not be deduced whether the disclosures are complete. The need for uniformity in documenting and substantiating the arm's length principle is also reinforced by Ignat, I. & Feleagă, L. (2019)¹. In terms of the relationship between related party transactions and corporate governance risk in Romania, related party transactions are prone to misuse by management, which threatens shareholder value. Also, independent non-executive directors are in a minority in Romania (Mihai et al, 2017)².

At an institutional level, the Audit and Assurance Committee (AAC) of the Institute of Chartered Accountants in England and Wales issued a practical guide for its members in 2010 which addresses practical issues relating to related party auditing. The suggestions offered are set out in the form of a five-point action plan to strengthen audit quality in this area³.

The subject of transfer pricing is a highly complex and broad interdisciplinary field, falling within the spheres of accounting, taxation, law and economics. It is in a constant state of dynamics and offers countless research opportunities. While the foreign scientific literature analysing transfer pricing is vast, as far as the domestic scientific literature is concerned, although a taboo subject in last years, transfer pricing has been brought to the public's attention more frequently in recent research. From the analysis of existing local articles, it was found that, until now, no analysis of the impact of transfer pricing on audit work has been addressed in terms of the implications for the company's image. Therefore, previous articles have led to the examination of the

relationship between transfer pricing and the financial audit process.

1.3. Considerations on the main provisions of the international and national auditing standards with regard to the analysis of transfer prices

The audit of transfer pricing is one of the most difficult parts of auditing the financial statements and is considered to be in the top 10 deficiencies of fraud audit cases⁴. Many companies carry out significant related party transactions as part of their normal business and these types of transactions can bring an increased distortion risk of the financial statements compared to transactions undertaken with unrelated parties. Risks may arise from:

- complex, circular transactions and with significant values;
- transactions with related parties located in different jurisdictions;
- preferential terms of transactions.

The International Auditing and Assurance Standards Board (IAASB) recognises the importance of transfer pricing in the audit of multinational entities and provides specific guidance in this regard. For example, International Standard on Auditing ISA 550 "Related Parties" addresses transfer pricing issues in the financial audit of entities that have cross-border operations or are involved in related party transactions. In the IAASB's view, auditors need to obtain an adequate understanding of related party transactions and the transfer pricing used to assess audit risk and obtain sufficient relevant and appropriate audit evidence. Auditors should be aware of the relevant tax laws and regulations in applicable jurisdictions and understand the impact of transfer pricing on the entity's financial statements and disclosures.

While Romanian tax regulations define related parties by very clear criteria, international auditing standards refer to the applicable reporting framework. Through IAS 24 "Related Party Disclosures", related parties are defined in a much broader sense than what is provided in the Fiscal Code, i.e.⁵:

The following terms are used in this Standard with the meanings specified: A related party is a person or entity that is related to the entity that prepares its financial

¹ Ignat, I., & Feleagă, L. (2019) *Research regarding the issues of the arm's length principle mentioned by IAS 24. Economic research-Ekonomska istraživanja*, 32(1), 3034-3051.

² Mihai, I. O., Radu, R. I., & Isai, V. (2017). *Corporate Governance and Related Parties Transactions - Evidence from Romanian Listed Companies*. In S. Hugues, & N. Cristache (eds.), *Risk in Contemporary Economy* (pp. 124- 134). Iasi, Romania: LUMEN Proceedings. <https://doi.org/10.18662/lumproc.rce2017.1.10>

³ Institute of Chartered Accountants in England and Wales, Audit and Assurance Faculty (2010), *The audit of related parties in practices*, <https://www.icaew.com/-/media/corporate/files/technical/audit-and-assurance/audit-and-assurance-faculty/publications/others/the-audit-of-related-parties-in-practice.ashx#:~:text=It%20requires%20auditors%20to%20consider,315%20and%202402%20on%20fraud>

⁴ Beasley et al. 2001 *Top 10 Audit Deficiencies*.

⁵ IAS 24 *Related Party Disclosures*.

statements (in this Standard referred to as a 'reporting entity').

(a) A person or a close family member of that person 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 a parent of the reporting entity.

(b) An entity is related to a reporting entity if any of the following conditions apply: (i) the entity and the reporting entity are members of the same group (i.e. each parent, subsidiary and associate subsidiary is related to the other); (ii) an entity is a joint venture or joint venture of the other entity (or a joint venture or joint venture of a member of a group of which the other entity is a member); (iii) both entities have 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 a related entity of 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 a parent of the entity); (viii) the entity or any member of a group of which it is a member provides key management personnel services to the reporting entity or parent of the reporting entity.

Close family members of a person are those family members who can be expected to influence or be influenced by that person in their dealings with the entity and include (a) the children and spouse or domestic partner of that person; (b) the children of that person's spouse or domestic partner; and (c) dependants of that person or that person's spouse or domestic partner.¹

A similar definition of affiliated parties is also found in Order No 1802/2014 issued by the Romanian Ministry of Finance for the approval of the accounting regulations regarding the individual annual financial statements and consolidated annual financial statements.

The auditor should pay particular attention to identifying transactions that, under the accounting definition, are considered to be undertaken with related parties and not

just transactions that are considered related party transactions as defined in the Fiscal Code.

Because related parties are not independent of each other, most financial reporting frameworks have specific disclosure and accounting requirements for balances, relationships and transactions with parties so that users of financial statements understand their nature and their actual or potential impact on the financial statements. If required by the applicable financial reporting framework, auditors should apply audit procedures to identify, evaluate and address risks of material misstatement arising from a company's failure to describe or present related party transactions or balances adequately.

In Romania, both Order no. 2.844/2016 issued by the Ministry of Finance for the approval of the Accounting regulations in accordance with the International Financial Reporting Standards and Order no. 1802/2014 require companies to disclose information on the identity of related parties and the transactions undertaken with them², such as: the name and registered office of each of the related parties, the proportion of capital held, the amount of capital and reserves as well as the profit or loss of the respective entity, the nature of the relationship with the related parties, and information on transactions with related parties and outstanding balances (e.g. amount of transactions, amount of outstanding balances, including commitments, details regarding guarantees offered or received, provisions for doubtful receivables related to the amount of outstanding balances).

With the adoption of ISA 701 "Communicating key audit matters in the independent auditor's report", auditors have been required to include in their reports key matters which, according to their own professional judgement, have the greatest significance in the audit of financial statements. In the case of companies with significant related party transactions, the auditor could include this matter in the audit report for greater transparency to users of financial information. A June 2023 study³ looked into the audit reports of listed companies in 31 countries and found that:

² Order no. 2.844/2016 issued by the Ministry of Finance for the approval of the Accounting Regulations in accordance with International Financial Reporting Standards, Section 2.2, letters e) and g) and Order no. 1.802/2014 for the approval of the Accounting Regulations on individual annual financial statements and consolidated annual financial statements, item 482, para. (1) and (2)

³ Pasc, Lioara-Veronica, Camelia-Daniela Hategan. 2023. Disclosure of Key Audit Matters: European Listed Companies' Evidence on Related Parties Transactions, *International Journal of Financial Studies*

¹ IAS 24 Related Party Disclosures.

- 61.29% of key audit issues related to related parties were reported by BIG4 auditors;
- 11 times more key issues were reported in 2021 than in 2016;
- most key issues concerning related parties were reported in the UK.

As part of an audit of related party transactions, the auditor may perform various tests to assess whether these transactions comply with accepted transfer pricing principles and tax regulations, as outlined below.

1. Comparability analysis of transfer prices:

- the auditor may perform a comparability analysis between the transfer prices charged/profit margins earned by the company in transactions with related parties and: (i) the prices charged/profit margins earned in similar transactions carried out by the company with independent parties, or (ii) the prices charged/profit margins earned in similar transactions carried out between independent parties on the market;
- this analysis may involve collecting market information, including quotes, offers, market surveys or conducting comparability/benchmarking studies in specific databases (e.g. Orbis) to assess whether transfer prices/profit margins are in line with market conditions and do not show significant deviations;
- one procedure available to the auditor is the request and review of the transfer pricing file, if available at the company level, as it should contain a comparability analysis for all categories of significant related party transactions undertaken by the company. If such a file does not exist, the auditor may recommend the preparation of one.

2. Evaluation of internal policies and procedures:

- the auditor may review the company's internal policies and procedures regarding related party transactions to assess the availability of adequate and well-documented policies for computing transfer prices;
- this involves assessing the existence and application of the transfer pricing policy, including the procedures for documenting and justifying the prices charged in transactions with related parties;

- an examination of the decision-making process regarding related party transactions and whether there is an independent committee within the company with responsibilities in this respect may also take place.

3. Verification of documents and accounting records:

- the auditor may perform a detailed review of the accounting documents and records relevant to related party transactions, such as contracts, invoices, accounting notes and other supporting documentation;
- this involves verifying the accuracy and completeness of accounting records and supporting documentation to ensure that related party transactions are properly recorded in accordance with relevant accounting principles and the company's transfer pricing policies.

4. Confirmation of related party transactions:

- the auditor may request direct confirmations from parties involved in intra-group transactions to verify the existence and accuracy of these transactions;
- confirmations may be requested from related parties.

As part of the risk assessment in the audit of related party transactions, the process of obtaining information is an important step as at this stage the auditor may also interview management about the identity of related parties, the nature of the entity's relationships with these parties and the list of transactions undertaken. According to ISA 550, the auditor should also inspect documents such as minutes of shareholder meetings and any other documents that may give indications of other transactions that management has not identified or presented to the auditor.

If the auditor identifies risk factors such as the dominant influence of related parties or unusual transactions that are outside the normal course of business, the auditor may also undertake an analysis to assess the risk of material misstatement due to fraud in accordance with ISA 240 "Auditor's responsibility to consider fraud in an audit of financial statements". The standard also provides guidance for when the auditor identifies transactions that the company has not disclosed, and the auditor has a responsibility to investigate the reasons why internal controls did not detect these transactions. If the failure to disclose transactions appears to be intentional, the auditor will apply the provisions of ISA 240 regarding the auditor's

responsibilities in relation to fraud and may request a new statement from the management regarding related parties and the transactions undertaken with them, at which time the auditor may reassess the credibility of information received from the management during interviews. It is important to note that there are other international auditing standards that may be relevant to such situations, such as ISA 315 'Identifying and assessing the risks of material misstatement through misunderstanding of entities and their environment'.

In conclusion, IAASB recognises the importance of transfer pricing in audit and provides specific guidance to auditors to assess audit risk and obtain appropriate audit evidence in relation to related party transactions and the transfer prices used by entities. This helps to ensure the transparency and integrity of the financial information in the context of entities' international operations.

2. Research methodology

In order to identify the main elements to be considered and analysed in the audit work in relation to related party transactions and transfer pricing, we have designed a case study, in which we went through the following steps:

- Step 1: Selection of three large Romanian companies that are part of groups of companies and are thus involved in transactions with related parties. For this purpose, we chose three of the companies listed on the Bucharest Stock Exchange included in the "Constituents index - BET" category;
- Step 2: Identify, on each company's website (in the section dedicated to investor information), the individual annual financial statements (including the notes to the financial statements) and the auditor's report for each year during the period 2018 – 2022 (it was considered that for the relevance of the analysis, a timeframe of 5 years is appropriate) and download them;
- Step 3: Review the individual annual financial statements and the auditor's report to identify those sections that deal with transfer pricing issues. The screening included searching for key words and phrases such as "transfer pricing", "related parties", "affiliated parties", "related parties", "group", "intra-group transactions", "subsidiaries";
- Step 4: Formulate conclusions on: (i) which sections of the financial statements and audit reports contain

references to transfer pricing, related party transactions and the need to comply with the arm's length principle in an intra-group context; and (ii) which informational items are included in these sections, as they in fact reflect some of the important elements to be investigated as part of an audit engagement from a transfer pricing perspective.

Finally, the conclusions formulated in this article are based both on a review of the legislation and literature as well as on the points resulted from the analysis of public information available to investors, i.e. the annual financial statements and audit reports.

3. Analysis of results

After going through the individual annual financial statements and the auditor's report for each of the three companies analysed for the period 2018 - 2022, several sections within these documents were identified, in which topics related to the companies' affiliation relationships and intra-group transactions are presented or discussed.

After going through the audit reports, it was found that 11 of them (approximately 70%) include mentions of issues arising from the specific way in which companies operate as part of groups (as recommended in ISA 701). Although, based on the limited information available, we cannot state with certainty that the companies in which investments were made, mentioned in the audit reports, or those referred to as "subsidiaries" meet the conditions set out in the Fiscal Code to be considered related parties / affiliated persons, we can nevertheless assume with a reasonable degree of certainty that this is the case.

The mentions can be found in the "Key audit aspects" section of the audit reports and cover the following issues:

- Treatment of investments, namely: impairment testing of investments in subsidiaries, recoverable amount of investment in a particular entity, valuation of investments in other companies and recoverability of investments in other entities; and
- Business continuity, i.e. the dependence of the audited company on its subsidiaries and its ability to continue its activity.

With regard to the treatment of investments, an additional issue that needs to be investigated before raising any questions about the initial price of the transaction is the extent to which the acquisition of the subsidiaries was made at a time when an affiliation relationship already

existed between the entities. To the extent that the answer is affirmative, the price applied as part of the acquisition transaction and booked as an investment (in the category of financial fixed assets) should have complied with the arm's length principle. The application of a price different than the one that would have been established between two independent partners directly influences both the information included in the balance sheet (through under or over evaluating the financial fixed assets) as well as the information included in the profit and loss account (through the subsequent recognition of possible impairment adjustments that directly influence the company's result).

With regard to business continuity, the existence of significant concerns on this topic has the direct consequence of changing the way in which balance sheet items are measured at the date of the financial statements.

Given the things previously mentioned, it can be concluded that, in principle, the fact that a company is part of a group creates a specific context that financial auditors should take into account in the audit engagement, with some of the specific situations that may arise falling into the category of key audit aspects.

The analysis of the financial statements showed the following:

- the balance sheet, profit and loss account, cash flow statement and statement of changes in equity have a rather limited information input in terms of reflecting affiliation relationships and transactions with related parties, comprising of an extremely limited number of specific indicators. This is primarily due to the fact that by nature they are centralising statements, intended to reflect an overview of a company's activity rather than a detailed one. Moreover, as there is a certain degree of freedom as to how the balance sheet, profit and loss account, cash flow statement and statement of changes in equity are structured and presented to investors, each company may decide whether or not to present certain detailed indicators on its intra-group operations; no consistency was observed from one company to another or, in the case of the financial statements prepared for the same company, from one financial year to another;
- the notes to the financial statements are those components of the annual financial reporting package that include detailed, highly informative items reflecting

affiliation relationships and transactions with related parties (in accordance with IAS 24). The details included relate mainly to the following items:

- company shareholders;
- remuneration of the company's management;
- list of subsidiaries/affiliated entities;
- balances of payables/receivables recorded in relation to subsidiaries/affiliated entities;
- value of transactions with subsidiaries/affiliates.

These are included mainly in the note reflecting transactions with related parties, but on a case-by-case basis they may be included in several different notes that fall within this theme but deal with specific issues such as financial assets, investments in subsidiaries, loans to subsidiaries, etc.

In addition, certain details of a company's related party transactions may also be found in other notes dealing with general issues (not necessarily related to the intra-group context) such as receivables, payables, goodwill, property, plant and equipment, etc. In other words, to the extent that the company's transactions with related entities give rise to significant liabilities, most likely there will be references in this respect not only in the note specifically detailing transactions with related parties, but also in the note detailing liabilities in general.

In the reporting process, emphasis is placed both on information regarding the collaboration between the company and its legal entities related parties (inside and outside Romania) as well as on information regarding the relationships with its natural persons related parties (e.g. natural persons shareholders or natural persons holding managerial positions which can be considered related parties by means of the control criteria). Also, in one of the companies whose financial reports have been analysed, the notes to the financial statements included information on transactions with other companies in which the majority shareholder of the company had control or significant influence.

- in general, for the reports prepared by the same company, there is consistency, from one financial year to the next, in the type of information presented regarding the affiliation relationships and the transactions with related parties. However, over time, an increase has been observed in the level of details

included, which can be seen as a consequence of the active concerns of potential investors/users of accounting information in relation to transfer pricing issues (concerns that companies need to address by providing relevant information);

- most of the time, the information included in the notes to the financial statements is aggregated at the level of structure elements of the financial statements (e.g. payables, receivables), without specific details on the nature of the transactions that generated them (e.g. purchase of raw materials, purchase of goods, provision of technological consultancy services, etc.), the context in which they took place or the way in which the price of the transactions was determined;
- in the case of the notes to the financial statements prepared for 2 out of the 3 companies, transfer pricing is also set out as an issue of interest in the section on "Commitments and contingent liabilities" / "Conditionalities". This includes a presentation of the obligations imposed on the company in relation to transfer pricing by the legislation in force and the opinion of the company's management on the compliance with these obligations and the possible risks that exist in this respect.

As a general conclusion, a company's affiliation relationships, transactions with related parties and transfer prices are of interest to users of accounting information and are reflected in a company's annual financial statements. In order to ensure compliance with the true and fair view principle, auditors should establish and apply specific procedures to verify that the company monitors affiliation relationships and properly records transactions with related parties (including, where possible, the compliance with the arm's length principle of such transactions).

In addition to the information specifically collected and presented by companies in their financial statements, as part of the audit process, for a better understanding of the intra-group transactions, additional details can be requested such as the list of transactions with related parties by type of transactions (taking into account the nature of the transactions) or the existence of documentation reflecting the compliance of transfer prices with the arm's length principle.

From this point of view, the main tool is the transfer pricing documentation file (which, in the case of companies classified as large taxpayers carrying out transactions with

related parties exceeding the materiality thresholds mentioned in Order No. 442/2016, must be prepared annually); however, companies may also use other tools such as transfer pricing policies (documents that show how intra-group transactions are carried out and how the transfer prices are computed as to comply with the arm's length principle) or benchmarking studies (analysis that reflect the profitability margins obtained on the market by independent companies involved in different activities / transactions, which can be used as a reference for profit margins used in an intra-group context).

The existence of such documentation and analysis at a company level gives a fairly strong indication that transfer pricing issues are high on the agenda of the company's management, which is aware of the provisions of the local legislation and actively monitors how transfer prices are determined in related party transactions, with the objective of managing them appropriately to eliminate any associated risks.

4. Conclusions

Today, transfer pricing is a central item on the agenda of taxpayers, tax authorities and regulators, with its influence manifested primarily in the fiscal area, respectively in the correct determination and proper allocation of the corporate tax base between different jurisdictions or between companies operating within the same jurisdiction. However, transfer pricing transcends the fiscal problematic and significantly influences other aspects of a company's life, one of which is the image reflected in the annual financial statements.

Transfer pricing is, therefore, also a reference point in the audit work carried out at the level of companies part of national or multinational groups and involved in significant intra-group transactions, as compliance or non-compliance with the arm's length principle directly influences the way in which different elements of income, expenses, results, assets, equity or liabilities are reflected or not in accordance with the true and fair view principle and thus, ultimately, the audit opinion.

In relation to the review of the transactions with entities that are part of the same group, both international and local bodies provide rules designed to standardise and facilitate audit work. However, the auditor often faces challenges in identifying and verifying the related parties of the audited company and the transactions taking place with them. These barriers are based on reasons such as

the lack of understanding of the arm's length principle, deficiencies in identifying related parties, communication deficiencies between the auditor and the person appointed by the company to maintain the communication as part to the audit process, deficiencies in internal control etc. However, the auditor can perform various tests to assess whether these transactions are in accordance with accepted transfer pricing principles and tax regulations, having access to various sources of information and assuming the responsibilities of the profession.

Although the balance sheet, profit and loss account, cash flow statement and statement of changes in equity have a rather limited information input in terms of reflecting affiliation relationships and transactions with related parties, comprising of an extremely limited number of specific indicators, the notes to the financial statements are those components of the annual financial reporting package that include detailed, highly informative items reflecting affiliation relationships and transactions with related parties. The details included relate mainly to the company's shareholders, the remuneration of the company's management, the list of affiliated entities, the balances of payables/receivables recorded in relation to affiliated entities or the value of transactions with related parties.

These are in fact also the elements that auditors should consider and investigate in their audit engagements, by establishing and using specific techniques and procedures, ensuring that the company monitors affiliation relationships and properly records transactions with affiliated persons (including, as far as possible, their

compliance with the arm's length principle). Only by doing this, it can be concluded that the transactions carried out in an intra-group context do not negatively impact the true and fair view to be reflected in the company's annual financial statements and do not diminish the relevance of the accounting information, in fact creating a distorted basis for decision making by users of accounting information.

In addition to the information specifically collected and presented by companies in their financial statements, as part of the audit process, for a better understanding of the intra-group transactions, additional details can be requested such as the list of transactions with related parties by type of transactions (taking into account the nature of the transactions) or the existence of documentation reflecting the compliance of transfer prices with the arm's length principle. From this point of view, the main tool is the transfer pricing documentation file; however, companies may also use other tools such as transfer pricing policies or benchmarking studies.

The analysis performed was based on a sample of observations considered relevant; however, as the amount of publicly available information is significant, the research can be extended by including new observations, thus increasing the statistical relevance. In addition, a possible area for further research may be to identify those audit techniques and procedures that are most frequently applied as part of the audit process of related party transactions, thus bringing a practical dimension to the issue.

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