

**RELATED PARTIES – ISSUES PAPER****Introduction**

The closing date for comments on the exposure draft (ED) of the proposed revised ISA 550, “Related Parties,” was April 30, 2006. A total of 41 comment letters have been received. A list of the respondents is included in the Appendix.

Generally, respondents expressed support for revising the ISA and, in particular, for adopting a risk-based approach. Most of the respondents provided input on the question posed in the explanatory memorandum regarding the appropriateness of establishing a requirement relating to dominant parties. The significant issues raised by the respondents are summarized below.

**Significant Issues****1. INTER-RELATIONSHIP WITH THE AUDIT RISK AND FRAUD ISAS**

In contrast to the procedural nature of the extant ISA, the proposed revised ISA adopted a risk-based approach to the audit of related party (RP) relationships and transactions. Several respondents<sup>1</sup> noted that the inter-relationship with the audit risk and fraud ISAs was unclear in the document. In particular, a number of them perceived a lack of context for the proposed risk assessment procedures, which they believed led these procedures to appear to be an isolated and complete set of procedures relating exclusively to RPs, although many of these derive from requirements in these other ISAs. Accordingly, they thought that more could have been done to explain this inter-relationship.

In addition, some questioned why, after requiring the auditor to perform risk assessment procedures, the proposed ISA did not also require the auditor to determine whether there were any actual risks of material misstatement resulting from RP activity, and whether such risks were significant risks. Some felt that the single focus on arm’s length assertions as a significant risk, without a more general assessment of the significance of other identified risks, was inappropriate.

Some of the respondents also felt that the proposed ISA gave the impression that *all* related party transactions (RPTs) represent significant risks. They argued that the vast majority of RPTs are routine transactions occurring mostly within groups of companies that do not represent significant risks. Accordingly, they thought that there should have been a greater emphasis in the proposed ISA on the fact that not all RPTs represent significant risks.

Two respondents (FEE and IDW) were of the view that the proposed ISA should distinguish between risks at the financial statement level and risks at the assertion level. They noted that the proposed ISA focused mainly on responses to risks at the assertion level, without due regard to overall responses to risk at the financial statement level. They argued that because of the inherent limitations associated with the audit of RP relationships and transactions, the resulting risk of misstatement at the financial statement level should be a significant risk. Accordingly, they suggested a number of overall responses to such risk for the proposed ISA:

- An emphasis on maintaining professional skepticism.

---

<sup>1</sup> ACCA, APB, DTT, EC, EY, FEE, IBR-IRE, ICAEW, ICAS, IDW, NIVRA and PwC

- Consideration of the control environment, which would lead to a greater emphasis on substantive procedures for weak control environments.
- The use of IT experts to assist in the identification of RP relationships and transactions from the entity’s electronic information system.
- The performance of substantive procedures early in the audit to identify RP relationships and transactions at an early stage.

The task force notes that the IAASB did not intend to establish a separate set of audit procedures for RPs independently of the audit risk and fraud ISAs. Rather, the intention was to develop the proposed ISA within the context of these other ISAs, without duplicating the requirements and guidance in these ISAs. However, the task force acknowledged the respondents’ comments that the proposed ISA could have better reflected its relationship with these other ISAs. Accordingly, in revising the wording of the proposed ISA, the task force has tried to better reflect this (e.g. see paragraphs 1, 12, 17, A6, A12, A23, and A38<sup>2</sup>).

The task force also agreed that the proposed ISA would give a more balanced message if it explicitly recognized that, in the majority of cases, RPTs are routine in nature and do not give rise to significant risks. Accordingly, guidance to that effect has been added in paragraph 2.

The task force, however, does not agree that there is a need to specify overall responses to risk at the financial statement level for RPs in this ISA. The task force’s view is that the risk arising from RPs at the financial statement level is an integral part of a broader fraud risk at the financial statement level. Therefore, the task force believes it is unnecessary to duplicate the requirement in ISA 240 for the auditor to determine overall responses to risks at the financial statement level. In addition, the task force is of the view that the overall responses suggested above are already included in existing ISAs in one form or another, and thus do not represent new approaches that respond uniquely to risks arising from RPs.

**Matters for IAASB Consideration**

- (a) Does the IAASB agree that the revised wording of the proposed ISA appropriately reflects the inter-relationship with the audit risk and fraud ISAs?
- (b) Does the IAASB agree that it would be unnecessary to provide specific guidance on overall responses to risks at the financial statement level for RPs?

**2. INHERENT LIMITATION IN IDENTIFYING RELATED PARTY RELATIONSHIPS AND TRANSACTIONS**

Paragraph 4 of the ED indicated that, for a number of reasons, there is an inherent limitation regarding the auditor’s ability to identify all RP relationships and transactions. There were a number of opposing views on exposure regarding whether such explanatory material was essential for the proposed ISA. Some respondents (e.g. CEBS and IOSCO) were of the view that highlighting the inherent limitation of the auditor’s ability to identify RP relationships and transactions projected a negative message in the ISA and simply reiterated the limitations implicit in an audit. These respondents recommended that such discussion be moved to ISA 200

<sup>2</sup> Paragraph numbers refer to the revised post-ED draft, unless otherwise noted.

and that the emphasis in the proposed ISA be changed to focus more on the need for the auditor to be even more alert in this area. Other respondents (e.g. CNCC, ICAEW and IDW) took an opposing view, commenting that the ED gave the impression that many more undisclosed RPTs can be expected to be brought to light. The latter group of respondents generally suggested the need for a clearer emphasis on the fact that a well-conducted audit performed in accordance with ISAs would not necessarily result in the detection of undisclosed RPTs, especially if those transactions are intentionally hidden.

Although the task force agreed that it would be appropriate to discuss the inherent limitations of an audit in a pervasive ISA such as ISA 200, the task force's view is that in this particular case, because of the risks arising from the special nature of RPs, it is important to highlight the inherent limitation in the auditor's ability to identify RP relationships and transactions in this ISA too. The task force, however, agreed to amend the wording of the explanatory material to achieve a more appropriate tone for the message (see paragraph 4).

#### **Matter for IAASB Consideration**

Does the IAASB agree that it would be appropriate to retain the explanatory material addressing the inherent limitation, suitably reworded?

### 3. DEFINITIONS BASED ON INTERNATIONAL ACCOUNTING STANDARD (IAS) 24, "RELATED PARTY DISCLOSURES"

Paragraph 7 of the ED proved to be controversial. This paragraph proposed RP definitions based on those in IAS 24 for the purpose of the ISA if the applicable financial reporting framework (FRF) does not establish RP requirements. Various respondents<sup>3</sup> raised the following concerns.

Some respondents (ACCA, AICPA, APB, FEE and ICAS) noted that the proposed definitions would only be applicable for FRFs that do not establish RP requirements, which meant that these definitions would not apply when the FRF establishes only limited (rather than no) RP requirements. They argued that this would result in the proposed ISA mandating the use of more extensive RP definitions in some jurisdictions than in others. These respondents felt that, without minimum definitions for audit purposes that would be applicable in all circumstances, auditors would apply the ISA inconsistently, with some interpreting the requirements broadly and others narrowly, depending on the definitions in the applicable FRF. Further, certain respondents noted that the requirement to obtain written representations would be difficult to implement satisfactorily in the absence of RP requirements in the applicable FRF, because the representations would not provide any assurance regarding RPs that are not defined in the framework.

Other respondents (Basel, HKICPA, ICAEW, IDW and PwC) pointed out the following practical difficulties or limitations to the proposal:

- The proposed ISA appeared to be used as a vehicle to compensate for perceived inadequacies in FRFs. The proposed definitions could thus be perceived as establishing requirements for management and those charged with governance through the "backdoor."

<sup>3</sup> ACAG, AG-NZ, ACCA, AICPA, APB, Basel, EC, FEE, GT, HKICPA, ICAEW, ICAS, IDW and PwC

- The proposed ISA appeared to involve the consideration of IAS 24 in isolation, even though IAS 24 is cross-referenced to other IFRSs. The proposal thus seemed to contradict the IAASB’s policy of promulgating framework-neutral ISAs.
- Defaulting to the IFRS definitions would set an impracticable benchmark in some circumstances, particularly in jurisdictions where government and state-owned enterprises play a significant role in the operations of many entities, such as in China. Consequently, it is difficult for management or the auditor in such jurisdictions to identify what is under “common control” or “influence.” It was argued that in some cases this has been the reason for not adopting IAS 24 in the local FRF.
- In jurisdictions where the definitions in the FRF are less comprehensive than those in IAS 24, management might not have established the necessary accounting systems to identify RPs and RPTs as defined by IAS 24.
- There are very few FRFs that do not deal with RPs at all, although many deal with them at a very high level. Accordingly, establishing the proposed definitions for the purposes of the ISA would appear to be an unnecessary complication.

Two respondents (IDW and PwC) suggested that, instead of establishing a rigid set of definitions for those circumstances where the FRF has no RP requirements, the proposed ISA should provide guidelines in general terms regarding the meaning of a related party to which the auditor could refer when applying the requirements of the ISA (similar to the approach adopted in the proposed revised ISA 320 for the definition of materiality).

After considering the possibility of establishing a minimum definition that should be applied in all circumstances, the task force came to the view that this would probably be going too far and could appear to be a somewhat heavy-handed approach to address what should be a minority of situations. Instead, the task force agreed with the above suggestion that it would be preferable to provide broad guidelines regarding the meaning of a RP based on the common characteristics of related parties (see paragraph 9). This approach allows sufficient flexibility for the auditor to exercise professional judgment in interpreting these general guidelines in the entity’s circumstances.

However, rather than limit these guidelines to situations where the FRF does not provide RP definitions or descriptions, the task force is of the view that these guidelines should be applicable regardless of the provisions of the FRF for the purpose of addressing the risks of material misstatement due to *fraud* (see paragraph 6 and 9). The task force believes that, where the FRF has weak or no RP requirements, these guidelines would provide the appropriate context or mindset for the auditor in performing procedures relating to transactions with such parties as are covered by the guidelines, for the purpose of fulfilling the auditor’s responsibilities relating to fraud. Where the FRF has RP requirements that are comparable to those of IAS 24, the task force is of the view that the guidelines proposed would not significantly extend the auditor’s responsibilities relating to fraud. In addition, the task force generally agreed that these guidelines should not be extended to consideration of risks of material misstatement due to *error*, as doing so would likely imply an override of the FRF for jurisdictions that have lesser requirements, through imposing what would effectively be an ISA definition.

The task force, however, did not reach a final conclusion regarding whether to apply these broad guidelines to all the requirements of the ISA, or whether they should be limited to certain requirements only. The task force notes that requirements in the proposed ISA that pertain to financial statement *disclosures* should only be applicable by reference to RP definitions set out in the FRF. However, from a practicability standpoint, isolating these specific requirements and applying the broad guidelines to the rest of the ISA would result in a somewhat cumbersome set of requirements and guidance. On a preliminary basis, pending further discussion with the IAASB, the task force proposes that the auditor considers these guidelines only for the requirements proposed in paragraphs 12 and 13. Paragraph A6 in the application material provides further explanation of how the auditor applies these guidelines in obtaining an understanding of how the entity is controlled or significantly influenced, and how it controls or significantly influences other RPs, for the purpose of addressing the auditor’s responsibilities relating to fraud.

#### **Matters for IAASB Consideration**

- (a) Does the IAASB agree with the approach taken to establish broad guidelines to describe the meaning of a related party for the purposes of addressing the risks of material misstatement due to fraud?
- (b) What are the IAASB’s views regarding whether these guidelines should apply to all the requirements of this ISA (except those pertaining to RP disclosures) or to only specific requirements?

#### 4. OBJECTIVE OF THE ISA

The proposed objective of the ISA drew numerous comments from respondents.<sup>4</sup> The most common concern was the seemingly inappropriate inclusion of a summary of requirements or procedures set out elsewhere in the proposed ISA, resulting in an objective that seemed unduly focused on process. Several of the respondents (APB, Basel, BDO, CEBS, CIPFA, FEE, IDW, IOSCO and UNICE) supported having an outcome-based objective. Two of them (FEE & IDW) emphasized that the auditor should only be obliged to “pursue” the objective rather than be required to achieve the outcome of the objective, given the inherent limitations regarding RPs.

Four other respondents (AG-NZ, IRBA-SA, NIVRA and NZICA) suggested that the objective should specifically include the identification of RPs and RPTs on the basis that such identification would provide a starting point for obtaining the information necessary to assess and respond to the risks resulting from the RP relationships and transactions.

One respondent (PwC) felt that the audit of RPs should not be an end in itself and that the objective should reflect the application of the audit risk ISAs in the context of identifying and appropriately responding to the risks resulting from RPs. Another respondent (EY) felt that the identification of RPs and the audit of RPTs should be responsive not only to the objective of the proposed ISA but also to those of other ISAs such as ISAs 330 and 240. This respondent noted that, because other standards would contribute to the achievement of the objective of the

<sup>4</sup> APB, Basel, BDO, CEBS, CIPFA, EY, FEE, IBR-IRE, ICAEW, ICAS, IDW, IOSCO, IRBA-SA, NIVRA, NZICA, PwC and UNICE

proposed standard, it would not be possible to evaluate the achievement of the proposed objective in isolation.

The task force notes that the Clarity task force is currently evaluating the most appropriate form and content of the objectives for all the ISAs. Accordingly, a final conclusion on the objective for this ISA may need to await the outcome of the Clarity task force's and the IAASB's deliberations on this issue. Subject to this, the task force has tentatively amended the proposed objective to align it with the draft objective for ISA 550 that the Clarity task force will present at the September 2006 meeting (see paragraph 8). The task force recommends that the IAASB reconsiders this issue at the next read of this proposed revised ISA.

#### **Matter for IAASB Consideration**

Does the IAASB agree that the issue of the objective of the ISA be reconsidered after the IAASB has finalized the objectives of the ISAs under the Clarity project?

#### **5. ARM'S LENGTH ASSERTIONS**

The ED proposed a definition of "arm's length transaction" and introduced a new requirement for the auditor to obtain sufficient appropriate audit evidence about an arm's length assertion.

One respondent (AICPA) argued strongly that the proposed definition was flawed in that it described such a transaction as one conducted on such terms and conditions as between a willing buyer and a willing seller *acting as if they were unrelated* and pursuing their own best interests. This respondent took a theoretical view that arm's length transactions could only be undertaken if the parties were in fact unrelated, as RPs cannot negotiate totally free of the influence of the relationship. Thus, it argued that an assertion about a RPT being undertaken on arm's-length terms should be limited to asserting *equivalency* to arm's length terms. Further, it suggested that the proposed guidance stating that an arm's length assertion might be capable of being substantiated even if based on significant assumptions should be deleted or revised, as such an assertion by its nature lacks the necessary objectivity and thus cannot be substantiated.

Although the task force agrees with the theoretical argument, the task force does not believe it will serve practical purposes to limit management to only stating that RPTs have been conducted on terms equivalent to arm's length terms (although management may choose to do so). The task force notes that transactions among components within a group, for instance, may very well be conducted at market prices that could be verified, and management may wish to assert that such transactions have been conducted on arm's length, commercial or market terms. Not allowing for such possibility through the definition in the ISA would expose the auditor to significant risk of disagreement with management on a theoretical point regarding a matter the substance of which may not in fact cause any disagreement. The task force therefore concluded that the proposed definition in the ED should remain unchanged. The task force also agreed that it would remain appropriate to treat an arm's length assertion for a RPT as a significant risk if management finds it difficult to substantiate the assertion (see paragraph 18). However, the task force does not agree that the guidance on evaluating significant assumptions supporting an arm's length assertion should be deleted, as quoted market prices may not be available in all cases. Finally, the task force has made a minor adjustment to the term defined from "arm's length transaction"

to “arm’s length assertion” as it is the latter term that is used in the proposed ISA (see paragraph 10).

Four respondents (APB, EC, FEE and IDW) noted a recent change to the European Commission’s 4<sup>th</sup> and 7<sup>th</sup> Directives which would require disclosure of transactions *not* conducted under normal commercial or market conditions. This would mean that, in the absence of an explicit assertion by management to the contrary, there would be an implicit assertion that RPTs were conducted on normal commercial or market terms if they are not disclosed. These respondents therefore suggested that the proposed ISA should allow for this situation. The task force agreed and has adjusted the requirements and guidance to recognize that arm’s length assertions may be explicitly stated in the disclosures or implied through non-disclosure (see paragraphs 18, 20 and A25). The task force does not otherwise believe that the proposed ISA should establish specific provisions to deal with the EC situation as the auditor should be able to take the actions that are appropriate in the circumstances of the FRF.

#### **Matters for IAASB Consideration**

- (a) Does the IAASB agree that the proposed definition of “arm’s length assertion” should remain unchanged?
- (b) Does the IAASB agree with the amended requirements and guidance to allow for the EC situation but not to otherwise establish specific provisions?

#### **6. DOMINANT PARTY**

Paragraph 11(b) of the ED proposed a requirement that, where a party appears to actively exert dominant influence over the entity, the auditor shall perform procedures intended to identify the parties to which the dominant party is related, and understand the nature of the business relationships that these parties may have established with the entity. This proposal proved to be controversial, drawing comments from many respondents.<sup>5</sup>

In response to the question posed in the explanatory memorandum, 9 respondents (ACAG, ACCA, AG-NZ, Basel, CIPFA, ICAP, IRBA-SA, NAO-UK and NZICA) specifically indicated that they agreed with the proposal, although some with reservations. Other respondents, however, expressed the following concerns.

Many of the respondents<sup>6</sup> felt that the proposal would not be consistently applied because the terms “dominant influence” and “dominant party” were undefined. They also commented that the ED did not provide guidance to illustrate the circumstances in which the auditor would identify a dominant party or dominant influence. In addition, some of them felt that there was ambiguity regarding the “parties” to which the dominant party is related.

Several of the respondents (e.g. BDO, CICA, CNCC, ICAEW, IDW, KPMG, NIVRA and PwC) were of the view that the proposal would not be workable or cost-effective because it was too open-ended. They believed it would set unrealistic expectations to require the auditor to perform

<sup>5</sup> ACCA, AG-NZ, AICPA, APB, Basel, BDO, CEBS, CICA, CNCC, CPA-AU, DTT, EC, EY, FEE, GT, HKICPA, ICAEW, ICAS, IDW, IOSCO, IBRA-SA, KPMG, NIVRA and PwC

<sup>6</sup> AG-NZ, AICPA, APB, Basel, CEBS, CPA-AU, DTT, EC, EY, GT, HKICPA, IBRA-SA, IOSCO and KPMG

unspecified procedures to identify the parties to which a dominant party is related and to understand the nature of the business relationships. Some of them also thought that the related procedures suggested in the application material (such as inquiry of the dominant party) would be impracticable, as there may be concealment and the dominant party would have no obligation to provide information to the auditor. Further, they argued that the proposal would effectively shift the primary responsibility for identifying such parties from management to the auditor.

Some respondents also expressed concern regarding the lack of guidance on the application of this proposal in SME audits. Since owner-managers would likely be considered dominant parties, they believed that the proposal would be unduly burdensome for these audits.

A number of the respondents (APB, CICA, FEE, ICAS, ICAEW, IDW, KPMG and PwC) suggested that a more practicable approach might be to position the procedure as a response to assessed risk, as opposed to a risk assessment procedure. This is on the basis that it would be more appropriate for the auditor to assess risks arising from dominant parties and other parties related to them based on the auditor's understanding of the entity and its internal control, and then to determine whether significant risks exist for which the procedures required in paragraph 11(b) of the ED would provide an appropriate response.

The task force notes that this requirement was proposed to enable the auditor to be more proactive in searching for unidentified or undisclosed RP relationships and transactions involving a dominant party. Given the practical issues raised by the respondents, however, the task force proposes that there be no specific requirement regarding identifying parties to which the dominant party is related. Instead, the task force proposes application guidance to highlight that the existence of a dominant party is a risk factor on its own, and to indicate that, if other risk factors are present, this may represent a significant risk (see paragraph A24). In addition, the task force proposes revised application guidance that addresses the auditor's response to a significant risk of material misstatement due to fraud as a result of the presence of a dominant party (see paragraph A30). This revised guidance suggests procedures that may be appropriate in such circumstances, consistent with the direction of the original proposed requirement in subparagraph 11(b) of the ED.

Finally, to respond to concerns about a lack of guidance as to the meaning of dominant influence, the task force proposes a definition (see paragraph 10) based on guidance in Appendix 1 of the extant ISA 240. Such a definition centers on individuals because the task force believes the exercise of dominant influence ultimately comes down to individuals. The exclusion of entities as dominant parties also avoids scoping in entities within groups (which would be appropriately audited as part of the group audits) and governmental bodies that hold ultimate control. The task force, however, does not believe that smaller entities should be specially exempted from considerations of dominant influence as the same risks may arise in such an environment.

#### **Matters for IAASB Consideration**

- (a) Does the IAASB agree with the revised approach to address risks arising from dominant parties?
- (b) Does the IAASB agree with the proposed definition of “dominant influence?”

## 7. RISK ASSESSMENT PROCEDURES VS RESPONSES TO ASSESSED RISKS

Paragraph 11 of the ED proposed to require the performance of the following risk assessment procedures specifically directed towards identifying RP relationships and transactions not identified or disclosed by management:

- (a) Inquiries of management and others within the entity about the existence of significant non-routine transactions;
- (b) Where a party appears to actively exert dominant influence over the entity, procedures intended to identify the parties to which the dominant party is related, and to understand the nature of the business relationships that these parties may have established with the entity; and
- (c) Review of appropriate records or documents (including, among others, bank and legal confirmations) for significant non-routine transactions and for other information that may indicate the existence of unidentified or undisclosed RP relationships or transactions.

In addition, paragraph 15 of the ED proposed in the risk assessment section that the auditor shall determine whether significant non-routine RPTs have been appropriately authorized and approved.

A number of the respondents<sup>7</sup> noted that these procedures appeared to be improperly characterized as “risk assessment” procedures. They argued that risk assessment procedures should serve to provide the auditor with an understanding of the entity, its environment and its internal control to enable the auditor to assess the risks of material misstatement in relation to RPs, and not to identify or detect additional RP relationships or transactions. Accordingly, they suggested that these procedures should only be required as responses to assessed risks, including significant risks.

One respondent (IDW) suggested that those audit procedures that should always be performed could be made requirements on the basis that the results of the assessment of risks cannot overcome the need to respond to the presumption that RP issues always represent a significant risk at the financial statement level (see also discussion in Issue 1).

The task force notes that, in developing the ED, the IAASB had debated whether these procedures should be risk assessment procedures or mandatory responses. The IAASB had decided to classify these audit procedures as risk assessment procedures to ensure that they would always be performed regardless of the assessed risks. The IAASB had concluded that RPs should not be considered as always representing a presumed significant risk at the financial statement level because doing so would involve, even for the simplest audit, the need to implement the substantial requirements that apply for significant risks (e.g. greater use of more experienced staff and tests of controls). In addition, the IAASB had taken the view that it would be difficult for the auditor to make a presumption of significant risk upfront without the benefit of more detailed work in understanding the entity.

However, taking into account specific comments from respondents on paragraph 11(a)-(c) of the ED (see Issues 6 and 8-9), the task force proposes to revise paragraph 11 of the ED so that the

---

<sup>7</sup> AICPA, FEE, IBR-IRE, ICAEW, ICAS and IDW

main focus of the risk assessment procedures is now more on making inquiries of management to obtain an understanding of the entity's RP relationships and transactions (see paragraph 13). The task force proposes to add a new requirement for the auditor to remain alert throughout the audit for transactions or other information that may indicate that the information obtained from those inquiries is incomplete, and to investigate if any unidentified or undisclosed RPs or RPTs are identified (further discussed in Issue 8). The task force believes this will reinforce the need for the auditor to be looking for unidentified or undisclosed RPTs when performing all other audit procedures, rather than being focused on the review of certain types of documents only. However, as more fully discussed in Issue 9, the auditor will continue to be required to specifically review bank and legal confirmations, and certain entity minutes because of their particular importance (see paragraph 16).

Finally, the task force agreed that the proposed requirement to obtain evidence about the authorization and approval of significant non-routine RPTs (paragraph 15 of the ED) should be reclassified as a response to assessed risk as it is more in the nature of a procedure performed to respond to identified risk. However, this procedure would be required for each significant non-routine RPT the auditor has identified because such a transaction, by its nature, gives rise to at least a risk of material misstatement. Accordingly, the task force proposes that for significant non-routine RPTs identified during the audit, the auditor shall obtain evidence that they have been appropriately authorized and approved (see paragraph 21).

The task force believes that the proposed approach described above will provide a reasonable basis for identifying and assessing the risks of unidentified or undisclosed RPs and RPTs and make a clearer differentiation between risk assessment procedures and responses to identified and assessed risks.

#### **Matters for IAASB Consideration**

- (a) Does the IAASB agree with the revised approach on risk assessment?
- (b) Would it be appropriate to classify the requirement to obtain evidence on the authorization and approval of significant non-routine RPTs as a response to assessed risk as explained above?

#### **8. SIGNIFICANT NON-ROUTINE TRANSACTIONS**

Paragraph 11 of the ED focused on the identification of previously unidentified or undisclosed RPs and RPTs through the performance of procedures directed towards significant non-routine transactions.

A number of respondents<sup>8</sup> expressed concerns regarding this approach. Some felt that there would be practical difficulties in inquiring of management regarding such types of transactions because, in the absence of an agreed definition, management would have its own interpretation of the meaning of the phrase "significant non-routine." It was also argued that the requirement seemed to cast a very wide net in the search for unidentified or undisclosed RPs and RPTs,

---

<sup>8</sup> ACCA, AICPA, CICA, DTT, EY, GT, HKICPA, IAFEI, ICAEW, KPMG and NIVRA

which could be ineffective from a cost perspective. Further, it was noted that the focus on significant non-routine transactions seemed to ignore unidentified or undisclosed *routine* RPTs.

Some of the respondents suggested the following alternative approaches:

- As ISA 315 requires the auditor to consider significant non-routine transactions in determining those risks that require special audit consideration, the consideration of the involvement of RPs in significant non-routine transactions could be related to those transactions identified as a result of the procedures applied in accordance with ISA 315.
- Rather than focusing on the characteristics of significance and level of routine, the auditor could focus on those characteristics of transactions that might be indicative of the existence of RPs, for example, terms that do not appear to be at arm's length.

In view of the practical concerns raised, the task force proposes that the requirement in ED subparagraph 11(a) be deleted. The task force agreed with the suggestion above that, rather than focusing on the characteristics of significance and level of routine, the proposed ISA could focus on those characteristics of transactions that may be indicative of the existence of RPs. Consequently, the task force proposes to replace the original requirement with a more general requirement for the auditor to be alert for transactions or other information that may be indicative of the existence of unidentified or undisclosed RP relationships or transactions (paragraph 16) (see also further discussion in Issues 7 and 9). In addition, the task force proposes guidance to describe some of the characteristics of transactions that may be indicative of the existence of RPs, drawn from the guidance in ISA 240 (see paragraph A18).

Paragraph A4 of the ED stated that significant transactions involving management or those charged with governance, or third parties related to them, are non-routine because of the nature of the related party relationships. It also stated that transactions may be regarded as significant where they appear to be significant to the related parties even though not material to the entity.

Some respondents (e.g. CICA, DTT, GT, IAFEI, ICAEW and NIVRA) questioned the practicability of the auditor making a determination as to whether transactions are significant to the RPs even though not material to the entity. They noted that it would be difficult for the auditor to fairly determine what is significant from the RPs' perspective. Further, they argued that the auditor's focus should be on material items, and materiality should be determined in the context of the entity's financial statements and not its RPs. They also questioned whether significant transactions involving management or those charged with governance should be non-routine by definition, as they believed some of these transactions could well be conducted in the normal course of business.

The task force accepted these comments and proposes that the related guidance be deleted.

#### **Matters for IAASB Consideration**

- (a) Does the IAASB agree that the proposed requirement for the auditor to inquire about the existence of significant non-routine transactions should be revised as discussed above?
- (b) Does the IAASB agree that the guidance in paragraph A4 of the ED should be deleted?

## 9. MANDATORY REVIEW OF RECORDS OR DOCUMENTS

Paragraph 11(c) of the ED proposed to require the auditor to review appropriate records or documents for transactions that are both significant and non-routine that may indicate the existence of previously unidentified or undisclosed RPs or RPTs. It also proposed that this review should include a review of bank and legal confirmations, minutes of meetings of shareholders and of those charged with governance, and other relevant statutory records.

Several respondents<sup>9</sup> disagreed with this proposal. Some noted that requiring specific records or documents to be reviewed could imply that the auditor would not need to have the same concerns for identifying RPs and RPTs when reviewing other records or documents. It was also observed that many of the other types of records or documents listed in the application material (paragraphs A7 and A8 of the ED) could be more helpful in identifying RPs and RPTs than the documents listed in the requirements section. Some argued that there would be a consistency issue as bank confirmations are not standardized throughout the world. In addition, the meaning of the term “statutory records” was questioned, as some believed it could be interpreted as meaning the entity’s accounting records.

Some respondents suggested a more principles-based approach to require the auditor to inspect those records or documents that, in the particular circumstances of the engagement, could indicate the existence of unidentified or undisclosed RPs and RPTs. This would encourage the auditor to consider other means of obtaining relevant information. Respondents also suggested that the three specific types of documents listed in the requirements section be moved to the application material.

In light of these comments, the task force reconsidered the proposed requirement. The task force generally does not agree that a requirement for the auditor to inspect records or documents that, *in the circumstances*, could indicate the existence of unidentified or undisclosed RPs and RPTs, would be appropriate because this would be too open-ended. The task force, however, concluded that there should be a requirement for the auditor to be alert for transactions or other information that may indicate the existence of unidentified or undisclosed RPs and RPTs when performing other audit procedures. This would appropriately place the auditor on notice for the possibility that new information on RPs might be found when performing other procedures (see paragraph 16). Such an approach would also respond to comments from several respondents<sup>10</sup> who argued that the proposed ISA should emphasize the need for the auditor to be especially alert to RPs and RPTs, given the inherently greater scope for misstatements.

The task force does not agree that the proposed requirement for the auditor to review bank and legal confirmations, and minutes of meetings of shareholders and of those charged with governance, should be moved to the application material, as the auditor should always review these documents *when they are available*. This has been clarified in paragraph 16. The task force, however, proposes that the requirement to review statutory records be deleted to respond to the concern noted above. Finally, the task force has revised the guidance to indicate that the various

---

<sup>9</sup> AICPA, CICA, GT, ICAEW, IOSCO, IRBA-SA and PwC

<sup>10</sup> AICPA, CEBS, CICA, FEE, GT, ICAEW, IOSCO and PwC

types of records or documents listed in the application material could be inspected by the auditor in the course of performing other audit procedures (see paragraphs A21).

#### **Matters for IAASB Consideration**

- (a) Does the IAASB agree that it would be appropriate to require the auditor to be alert for transactions or other information that might indicate the existence of previously unidentified or undisclosed RP relationships and transactions?
- (b) Does the IAASB agree that it remains appropriate to require the auditor to inspect bank and legal confirmations, and minutes of meetings of shareholders and of those charged with governance when these are available?

#### 10. “MISLEADING” TEST

Paragraph 23(c) of the ED introduced the requirement that irrespective of the FRF, the auditor shall evaluate whether the effects of the RP relationships and transactions could result in the financial statements being misleading in the circumstances of the engagement.

This proposal elicited significant concerns among some respondents.<sup>11</sup> Among the most significant issues raised:

- Unless the definitions included in the Appendix to the ED are established as a minimum standard, the evaluation required would be difficult to perform.
- The ED did not provide any practical guidance or suitable criteria to help the auditor evaluate whether the financial statements are misleading.
- The term “misleading” was not defined.
- The issue applies to many ISAs, particularly the reporting ISAs. Thus, the “misleading” issue would be better dealt with outside the proposed ISA (e.g. in ISAs 200 or 500).
- In many civil law jurisdictions, financial statements that comply with the applicable FRF (i.e. “compliance frameworks”) will not be misleading by definition. The auditor would not be able to override a legally enforceable FRF in such a jurisdiction.
- For compliance frameworks that do not require fair presentation, the application of a “misleading test” beyond the requirements of the applicable FRF would lead to the auditor assuming greater responsibility for the financial statements than management.
- In many FRFs, there are requirements for the disclosure of RPTs in the group financial statements but not in those of subsidiaries. If the subsidiaries’ financial statements are considered in isolation, they might be considered misleading.
- By referring to the IFAC Code of Ethics in providing context to the term “misleading,” the IAASB appeared to be interpreting for auditors’ purposes the requirements of the Code applicable to all professional accountants. This might be inconsistent with the Code’s own guidance on the meaning of the term “misleading” for professional accountants in business.

---

<sup>11</sup> AICPA, APB, CICA, EC, EY, FEE, ICAEW, IDW and IOSCO.

One respondent (APB) suggested that the need to introduce the concept of “misleading” seemed to arise in relation to those countries where the applicable FRF neither requires the financial statements to give a “true and fair view” nor has detailed disclosure requirements relating to RPs that support a “fairly presented” approach. It noted that such countries would likely to be in a minority and, accordingly, attempting to deal with such situations could result in the development of requirements and guidance that lack clarity for the majority of jurisdictions. This respondent suggested that for the majority of countries, the requirement should be for the auditor to evaluate whether sufficient appropriate disclosure of the effects of RP relationships and transactions has been provided for the financial statements to give a true and fair view, or be fairly presented, in all material respects.

The task force acknowledged these concerns. The task force came to the view that the issue regarding the possibility of the financial statements being misleading because of RPTs arises primarily in relation to fraud. Given the proposed expanded definition of RPs in paragraph 9 of the revised draft to address fraud considerations, the task force agreed in principle that the misleading test should no longer be necessary. In addition, the task force notes that the issue of the misleading test is currently being addressed by the ISA 701 task force in relation to special purpose engagements. The task force understands that the IAASB’s intention is address the issue at a more general level and that any guidance developed to that effect would be placed in the proposed new ISA XXX, “Evaluating Audit Evidence and Forming an Opinion on the Financial Statements.” For these reasons, the task force proposes to delete the specific requirement and guidance relating to the misleading test from the proposed revised ISA 550. The task force also agreed that such a deletion would not constitute a change in principle because the matter would now be addressed in another ISA in a more general way.

#### **Matter for IAASB Consideration**

Does the IAASB agree not to address the issue of the misleading test in this ISA for the reasons explained above but in the proposed new ISA XXX, “Evaluating Audit Evidence and Forming an Opinion on the Financial Statements?”

## 11. OTHER ISSUES

### (a) *Written Representations*

Paragraph 24 of the revised draft requires the auditor to obtain written representations from management and, where appropriate, those charged with governance concerning:

- Whether related party transactions and the effects of related party relationships have been appropriately accounted for, including whether the financial statements reflect the economic substance of these relationships and transactions; and
- Whether the related party disclosures in the financial statements are appropriate.

Although the requirement to obtain these two types of representations is essentially unchanged from the exposure draft, the task force was divided as to whether these representations are general representations in nature and, therefore, whether the auditor should obtain them. The task force notes that the broader issue of whether the auditor should obtain general representations

from management is currently being addressed by the ISA 580 project. Accordingly, the task force would like to highlight to the IAASB that a conforming amendment to the revised ISA 550 could be required at a subsequent stage, depending on the final resolution of the broader general representation issue under the ISA 580 project.

**Matter for IAASB Consideration**

What are the IAASB's views regarding the nature of these representations, and does the IAASB remain of the view that they should be required?

*(b) Communication with Those Charged with Governance*

Paragraph 24 of the ED proposed the requirement that the auditor communicate with those charged with governance the nature, extent, business rationale and disclosure of significant RP relationships and transactions, including those involving actual or perceived conflicts of interest.

A number of respondents<sup>12</sup> strongly opposed this proposal, arguing that such communication is management's responsibility and not the auditor's, and that it would be onerous as it would require the auditor to compile a complete list of RPTs. In addition, they thought that communicating the business rationale of the RPTs would be excessive for SMEs, and that it should be the responsibility of those charged with governance to obtain an understanding of the business rationale of significant RPTs. One respondent (AICPA) suggested that the auditor's only responsibility should be to determine whether management has made the communication.

The task force acknowledged the practical issues raised and proposes to delete the requirement for the auditor to communicate the nature, extent, business rationale and disclosure of significant RP relationships and transactions with those charged with governance (see paragraph 25). The task force does not agree that the auditor should be responsible for determining whether management has made the communication to those charged with governance because management may not have such a responsibility. In addition, this could be interpreted as introducing through the ISA an implicit requirement on management to communicate those matters to those charged with governance. On the other hand, the task force believes it is important to encourage dialogue between the auditor and those charged with governance about RPs and RPTs. Therefore, the task force proposes that the requirement should focus on the communication of significant related party *issues* the auditor has identified during the audit, including conflict of interest issues.

**Matter for IAASB Consideration**

Does the IAASB agree to revise the proposed requirement as discussed above?

*(c) The Role of Management and those Charged with Governance*

Six respondents<sup>13</sup> argued strongly that the proposed ISA did not sufficiently address management's primary responsibility for designing and implementing appropriate controls for

<sup>12</sup> AICPA, APB, BDO, CPA-AU, DTT, HKICPA, ICAEW, KPMG and PwC

<sup>13</sup> CNCC, DTT, EY, FEE, ICAEW and NIVRA

the identification, appropriate accounting for, and disclosure of RPs and RPTs. They pointed out that the proposed ISA was not sufficiently balanced in that it imposed a responsibility on the auditor to identify RPs and RPTs but was silent on the corresponding responsibilities of management and those charged with governance. These respondents noted that acknowledging and describing the respective responsibilities of management, those charged with governance, and the auditor in the proposed ISA would assist the reader in better understanding the inherent limitation on the auditor's ability to identify RP relationships and transactions. They also suggested that doing so would help manage users' expectations regarding what the auditor can achieve.

The task force notes that the IAASB had considered including guidance describing the responsibilities of management and those charged with governance in the ED but decided otherwise as such guidance was addressed in a more general way in ISA 200. In view of the respondents' comments, however, the task force concluded that it would be desirable to include specific guidance on the responsibilities of management and those charged with governance regarding related parties in the application material of the proposed ISA to provide a more balanced view of the various responsibilities of the parties involved. This guidance has been attached to the requirement to understand the entity's controls over RP relationships and transactions (see paragraph **A11**).

**Matter for IAASB Consideration**

Does the IAASB agree that it would be appropriate to provide guidance on the responsibilities of management and those charged with governance regarding RPs?

**(d) Group Audits**

Four respondents<sup>14</sup> noted that the proposed ISA did not appear to deal adequately with the auditor's responsibilities in relation to transactions between group companies, nor did the proposed revised ISA 600 regarding group audits. They were of the view that one of the most challenging aspects of many group audits is obtaining sufficient appropriate evidence regarding transactions between components due to the volume of the transactions and the associated issues surrounding communications with other auditors. In addition, they noted that even though transactions between group components would be eliminated on consolidation, there might nonetheless be risks of misstatement arising from such transactions. Further, the proposed ISA did not address how the auditor should fulfill the responsibilities under the ISA within the context of a group audit. Accordingly, they suggested that either this ISA or the proposed group audits ISA should deal more comprehensively with the audit of transactions between group companies.

The task force is generally of the view that if a component within a group is required to issue individual audited financial statements, the audit of transactions between that component and other components within the group would be no different from the audit of transactions between the component and other unrelated entities. For example, the same considerations of fraud would apply to these transactions and the same requirements to identify, assess and respond to the risks

<sup>14</sup> APB, FEE, ICAEW and PwC

of material misstatement regarding these transactions would need to be addressed. Accordingly, the task force generally does not believe there is a need to develop specific guidance to address the audit of related party transactions at the component level for components within a group.

**Matter for IAASB Consideration**

Does the IAASB agree that it would be unnecessary to develop specific guidance to address the audit of RPTs at the component level for components within a group?

## Appendix

### List of Respondents

IFAC member bodies: 19

Regulators: 4

Firms: 6

Governmental: 5

Others (standard setters, industry, etc.): 7

#	Respondent	Ref	Group
1	American Institute of Certified Public Accountants	AICPA	Member Body
2	The Association of Chartered Certified Accountants	ACCA	Member Body
3	Auditing Practices Board (United Kingdom)	APB	Other
4	Office of the Auditor-General of New Zealand	AG-NZ	Governmental
5	Australasian Council of Auditors-General	ACAG	Governmental
6	Audit Commission United Kingdom	AC-UK	Governmental
7	Basel Committee on Banking Supervision	Basel	Regulator
8	BDO Global Coordination B.V	BDO	Firm
9	China Association of Chief Financial Officers	CACFO	Other
10	The Canadian Institute of Chartered Accountants	CICA	Member Body
11	CPA Australia	CPA Au	Member Body
12	Chartered Institute of Public Finance and Accountancy	CIPFA	Member Body
13	Committee of European Banking Supervisors	CEBS	Regulator
14	Compagnie Nationale des Commissaires aux Comptes + Conseil Supérieur de l'Ordre des Experts-Comptables	CNCC- CSOEC	Member Body
15	Deloitte Touche Tohmatsu	DTT	Firm
16	Den Norske Revisorforening	DnR	Member Body
17	Ernst & Young Global	EYG	Firm
18	European Commission	EC	Regulator
19	Federation des Experts Comptables Europeens	FEE	Other
20	Grant Thornton International	GT	Firm
21	Hong Kong Institute of Certified Public Accountants	HKICPA	Member Body

#	Respondent	Ref	Group
22	Institut der Wirtschaftsprüfer	IDW	Member Body
23	Institut des Reviseurs d'Entreprises/ Instituut der Bedrijfsrevisoren	IBR-IRE	Member Body
24	Institute of Chartered Accountants of Pakistan	ICAP	Member Body
25	Institute of Certified Public Accountants of Cyprus	ICPAC	Member Body
26	Institute of Certified Public Accountants of Singapore	ICPAS	Member Body
27	Institute of Chartered Accountants in England and Wales	ICAEW	Member Body
28	Institute of Chartered Accountants of Scotland	ICAS	Member Body
29	Institute of Chartered Accountants of Zimbabwe	ICAZ	Member Body
30	International Association of Financial Executives Institutes	IAFEI	Other
31	International Organization of Securities Commissions	IOSCO	Regulator
32	International Organization of Supreme Audit Institutions	INTOSAI	Governmental
33	Independent Regulatory Board for Auditors, South Africa	IRBA-SA	Other
34	The Japanese Institute of Certified Public Accountants	JICPA	Member Body
35	KPMG	KPMG	Firm
36	National Audit Office, UK	NAO	Governmental
37	Koninklijk Nederlands Instituut van Registeraccountants (Royal NIVRA)	NIVRA	Member Body
38	New Zealand Institute of Chartered Accountants	NZICA	Member Body
39	PricewaterhouseCoopers	PwC	Firm
40	Registro de Economistas Auditores (REA)	REA	Other
41	Union of Industrial and Employers' Confederations of Europe	UNICE	Other

**[Blank Page]**