



International Federation of Accountants

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Agenda Item

9

Committee: IAASB
Meeting Location: London
Meeting Date: December 4-8, 2006

Related Parties

Objective of Agenda Item

1. To review a second-read draft of the proposed revised ISA 550, *Related Parties*, post-exposure.

Task Force Composition

2. The members of the task force are:
 - Gérard Trémolière – Chair, IAASB Member (assisted by his Technical Advisor Cédric Gélard)
 - Jon Grant – IAASB Technical Advisor
 - Diana Hillier – IAASB Member
 - Greg Shields – IAASB Technical Advisor
 - Makoto Shinohara – IAASB Member (assisted by his Technical Advisor Yuichi Yamamoto)
 - John Thorpe – INTOSAI Representative

Activities since Last IAASB discussions

3. The task force met in October and November to discuss the comments received from the IAASB and the IAASB CAG in September on the significant issues raised by respondents to the exposure draft. The task force held a subsequent conference call to finalize the wording of the revised draft of the ISA now being presented.

Significant Issues

- A. RELATED PARTY DEFINITIONS
4. At the September meeting, the IAASB considered the issue of how the ISA should define a related party when the applicable financial reporting framework establishes limited or no related party definitions and requirements. The task force proposed the adoption of an approach based on the provision of general guidelines regarding the characteristics commonly found in related party relationships. The task force believed these guidelines would provide the auditor appropriate flexibility in judging which party should be deemed related in the entity's circumstances (absent any definition in the framework), and would provide an appropriate

context for the auditor when performing procedures to fulfill the auditor’s responsibilities in relation to fraud. CAG representatives generally expressed support for this approach.

5. Some IAASB members, however, noted that the interaction between inadequate financial reporting frameworks and these proposed guidelines was not clearly explained in the revised draft of the ISA. Further, it was noted that the revised wording seemed to suggest that if the applicable financial reporting framework has no related party definitions and requirements, the risk of fraud is higher. Accordingly, it was suggested that the introductory material in the revised draft should be reworded so as to better link financial reporting issues pertaining to framework requirements with the related party definitions set out in the framework, and issues pertaining to understanding related party relationships and transactions in the context of fraud with the related party characteristics proposed.
6. In light of these comments, the task force decided that it was important to step back and reflect on the auditor’s responsibilities in relation to related parties in an audit of financial statements, as the purpose of having a definition of related parties is to enable the auditor to fulfill those responsibilities. The task force’s view is that these responsibilities may be categorized as follows:
 - a) Where the framework has established specific related party definitions and requirements, the auditor has a responsibility to identify and assess the risks of material misstatement due to error that may arise from management’s failure to account for or disclose related party relationships and transactions as required by the framework;
 - b) Even if the framework establishes minimal or no related party definitions and requirements, the auditor has nevertheless a responsibility to obtain an understanding of the relationships and transactions between the entity and parties that would be deemed related in order to identify and assess the risk that the financial statements, as a whole, either:
 - do not achieve fair presentation (if the financial statements are prepared and presented in accordance with a fair presentation framework); or
 - are misleading (if the financial statements are prepared and presented in accordance with a compliance framework)
 as is required in ISA 700 (as revised in the ISA 800 project). This may be the case if the financial statements do not appropriately reflect the economic reality¹ of the relationships and transactions (a “stand-back” test); and
 - c) The auditor also has a responsibility to identify fraud risk factors arising from the entity’s related party relationships and transactions in order to identify and assess the risks of material misstatement due to fraud as required in ISA 240 (see paragraphs 5-7).

¹ The task force felt that the term “economic reality” is more appropriate in this context than “economic substance” as there is a greater potential for some to misinterpret the latter term to imply a requirement for all related party transactions to be accounted for on arm’s length terms.

7. With regard to the first category, the definition of related parties in the applicable financial reporting framework is relevant.
8. With regard to the second category, the task force believes that the auditor has a responsibility to consider the impact of related party transactions and arrangements, even if the framework establishes no related party accounting and disclosure requirements. ISA 700, as revised in the ISA 800 project, requires the auditor to evaluate whether the financial statements achieve fair presentation or are misleading (depending on whether the framework is a fair presentation or compliance framework, respectively). Transactions and arrangements involving related parties may affect the fair presentation of the financial statements, or render them misleading, if how they are reflected in the financial statements distorts the economic reality of the entity's financial position and results. For example, the sale of a property to a major shareholder may need to be accounted for as a capital withdrawal or dividend distribution rather than a transaction involving a loss for the entity. Alternatively, if the entity's ability to continue as a going concern depends on guarantees of financial support from a related party, failure to disclose that fact could be misleading (see paragraph A2).
9. Accordingly, the auditor needs to obtain an understanding of transactions and arrangements with related parties sufficient to apply such a "stand-back" test, regardless of the extent to which the framework has prescribed related party definitions and requirements. The auditor's focus in this regard would be on understanding the nature and business rationale of significant transactions and arrangements outside the normal course of business (see also Issue D below). Unless the financial reporting framework has specific accounting or disclosure requirements for related parties and related party transactions, it is not necessary for the auditor to perform procedures to identify a complete list of all related parties and transactions with them. Therefore, a precise definition of related parties is not needed to fulfill this aspect of the auditor's related party responsibilities. Rather, what is needed is a definition that provides a frame of reference to help identify types of relationships through which the entity may conduct transactions or arrangements that are outside of the normal course of business.
10. The third category reflects the IAASB consensus that where fraud is concerned, the scope of the auditor's procedures should not be strictly limited to the related party definitions set out in the framework. The auditor's objective, in relation to this aspect of the auditor's related party responsibilities, is the identification of fraud risk factors that may exist because of the entity's related party relationships. In particular, parties who are not independent of the entity by virtue of having the ability to control or significantly influence the entity (or vice versa) are relevant to the auditor's identification of fraud risk factors because such relationships can create the opportunity and/or incentive for fraud. ISA 550 is intended to effectively link with, and not duplicate, ISA 240. Consistent with ISA 240 and the approach noted in paragraph 9 above, in identifying fraud risk factors, the auditor's focus is on understanding the nature and business rationale of significant transactions and arrangements outside the normal course of business and determining whether related parties are involved, instead of trying to identify a complete list of all related parties and related party transactions.
11. Therefore, to better support the requirements relevant to the second and third categories, the task force is proposing a generic definition of a related party in terms of the party having the ability to control or significantly influence the entity (or vice versa) (see paragraph 13(c)). The

task force further agreed that, while the guidelines on the common related party characteristics it originally proposed remain appropriate and would support this generic definition, such guidelines should be more appropriately placed in the application material in view of their illustrative and explanatory nature (see paragraph A1).

12. The task force's view is that this related party definition and the related guidelines should be used by the auditor as a context to guide the auditor in fulfilling the second and third categories of responsibilities. Accordingly, as indicated above, there is no intention – and the requirements do not impose any obligation – that the auditor should produce or accumulate a list of all parties that might meet this definition or that might fall within the proposed guidelines. This would, however, not prevent the auditor from explaining the definition or guidelines to management for the purpose of furthering the auditor's procedures.
13. The task force also believes that the categorization of the auditor's responsibilities based on the nature of the underlying risks, as described above, provides a clearer structure to the proposed ISA, and helps to more clearly specify the applicable requirements as well as the objectives of the ISA (see paragraph 12). The Appendix provides an overview of the revised structure and the requirements that relate to the three types of responsibilities.

Matters for IAASB Consideration

- Q1. Does the IAASB agree with the proposed approach to related party definitions and the related auditor responsibilities as described above?
- Q2. Does the IAASB agree with the proposed related party definition?

B. INHERENT LIMITATIONS IN THE CONTEXT OF RELATED PARTIES

14. At the September meeting, the IAASB agreed that, in view of the particular risks associated with related parties, it would be appropriate to include in the proposed ISA explanatory material describing the inherent limitations of the audit in the context of related parties. CAG representatives also expressed support for including such material in the proposed ISA.
15. Part of the inherent limitations wording the task force had proposed stated that “the requirements of the ISA provide a reasonable basis for obtaining sufficient appropriate audit evidence about the accounting for, and disclosure of, related party relationships and transactions.” It was noted that such wording appeared inconsistent with the revised Preface in that it seemed to suggest that having complied with the requirements, the auditor would necessarily have achieved the objective of the ISA. It was also noted that the term “reasonable basis” overlapped to some extent with the term “sufficient appropriate audit evidence.”
16. In addition, it was pointed out that the inherent limitations described in the introductory section seemed to relate only to the risks of material misstatement, and that a link seemed to be missing between these inherent limitations and the consequent inherent limitation on the effectiveness of the auditor's procedures.
17. In light of these comments, the task force has reconsidered the wording used to describe the inherent limitations in the proposed ISA. Given the similarities between this ISA and ISA 240

in relation to fraud, the task force agreed to follow the approach that has been taken in ISA 240 when describing the inherent limitations in the context of fraud. The revised wording in paragraph 9 now states that inherent limitations regarding the auditor's ability to detect material misstatements resulting from related parties arise primarily because related party relationships may present a greater opportunity for collusion, concealment or manipulation by management. This recognizes that the inherent limitations arise primarily in relation to identification issues. The revised draft accordingly emphasizes the importance of maintaining professional skepticism throughout the audit, and indicates that the requirements in the ISA are designed to assist the auditor in identifying and assessing the risks of material misstatement resulting from related parties, and in designing procedures to respond to such risks (see paragraph 10).

18. The task force believes that the revised wording provides an appropriately balanced message between highlighting the inherent limitations arising from related parties which, by their nature, cannot be overcome, and the requirements of the proposed ISA that are designed to mitigate the risk that material misstatements resulting from related parties may not be detected. The task force did not believe it necessary to emphasize the inherent limitation on the effectiveness of the auditor's procedures, as this is implicit in the statement in paragraph 8 that there is an unavoidable risk that some material misstatements of the financial statements will not be detected, even though the audit is properly planned and performed in accordance with the ISAs.
19. To better reflect the particular risks arising from related parties at the entity level, the task force has also amended the introductory material to more closely link the nature of related party relationships and transactions to the higher risks of material misstatement resulting from related parties, as opposed to the higher risk of the auditor not detecting such misstatements (see paragraphs 2-3).

Matters for IAASB Consideration

- Q3. Does the IAASB agree with the revised wording of the introductory material on inherent limitations?
- Q4. Does the IAASB agree with the amended introductory material regarding the linkage between the nature of related party relationships and transactions and the higher risks of material misstatement resulting from related parties?

C. NATURE AND EXTENT OF RISK ASSESSMENT PROCEDURES

20. CAG representatives generally supported the revised approach to risk assessment procedures in the revised draft discussed in September, but felt that the linkage to ISAs 315 and 240 could be further tightened. At the September IAASB meeting, it was also noted that the risk assessment procedures in the revised draft seemed to be limited to inquiries of management and maintenance of alertness to relevant related party information.
21. In light of these comments, the task force agreed to revise the draft wording to further tighten the linkage between the proposed ISA and ISAs 315 and 240. The task force also agreed to

further explain that the risk assessment procedures specified in the proposed ISA are not intended to be viewed as an isolated set of procedures but are part of the other risk assessment procedures required by ISA 315 (see paragraphs 14 and A3).

22. At the September meeting, it was also noted that the proposed draft did not appear to elaborate on the implications of related party controls that are inadequate or non-existent. It was noted that in the absence of adequate controls, the auditor may have to resort to a fully substantive approach. It was suggested that in such a situation, the auditor may be unable to obtain sufficient appropriate audit evidence regarding related party relationships and transactions and may need to consider the implications on the audit opinion.
23. The task force agreed that it would be appropriate to clarify that if controls over related party relationships and transactions are inadequate or non-existent, the auditor may not be able to obtain sufficient appropriate audit evidence about such relationships and transactions. This is because management would have no basis for providing related party information to the auditor and would be unable to represent that any such information provided to the auditor is complete. The task force, however, agreed that it would be important to emphasize that this implication would be more relevant in the larger, more complex entities. This clarification has been made in paragraph A12. The task force did not believe it necessary to further elaborate on the implications of an inability to obtain sufficient appropriate audit evidence as such a situation is addressed under ISA 705, “Modifications to the Opinion in the Independent Auditor’s Report.”

Matter for IAASB Consideration

- Q5. Does the IAASB agree that the linkage to ISAs 315 and 240 has been appropriately tightened and that the nature and extent of the risk assessment procedures has been appropriately clarified as explained above?
- Q6. Does the IAASB agree with the clarification provided in the application material regarding the implications of inadequate or non-existent related party controls?

D. SIGNIFICANT TRANSACTIONS OUTSIDE THE NORMAL COURSE OF BUSINESS

24. The exposure draft focused on the identification of previously unidentified or undisclosed related party relationships and transactions through the performance of procedures specifically directed towards the identification of significant non-routine transactions. As reported at the September meeting, many respondents expressed concerns regarding this approach as they believed there would be practical difficulties, particularly in inquiring of management regarding such types of transactions in the absence of an agreed definition of a significant non-routine transaction. Respondents also argued that the proposed approach would cast a wide net in the search for unidentified or undisclosed related party relationships and transactions, which they felt would not be cost effective.
25. In light of the comments made at the September IAASB meeting regarding the extent of the risk assessment procedures (see Issue C above), the task force has reconsidered the approach to significant non-routine transactions (i.e. significant transactions outside the normal course of

business, to be consistent with terminology used in ISA 315). The task force agreed that although there is no specific requirement in ISA 315 or elsewhere in the ISAs for the auditor to search for such transactions, many of the risk assessment procedures the auditor is required to perform under ISAs 315 and 240 to obtain an understanding of the entity and assess risks will lead to the identification of significant transactions and arrangements outside the normal course of business. In particular, the task force is of the view that such transactions and arrangements could be identified from work performed to obtain an understanding of the controls management has established to authorize and approve transactions and arrangements outside the normal course of business. While these controls may not always exist or be adequate, there is a greater likelihood of the auditor identifying any significant transactions and arrangements outside the normal course of business when performing work to understand such controls.

26. Accordingly, the task force proposes that in performing procedures to understand the entity's controls over related party relationships and transactions, the auditor should also obtain an understanding of the controls management has established to authorize and approve transactions and arrangements outside the normal course of business (see paragraph 17(b)). Finally, the task force proposes a new requirement in paragraph 18 that if, during the course of the audit, the auditor has identified significant transactions and arrangements outside the normal course of business, the auditor shall inquire of management to understand their nature and business rationale, and whether they involve parties that control or significantly influence the entity, or that the entity controls or significantly influences.

Matter for IAASB Consideration

- Q7. Does the IAASB agree with the revised approach to significant transactions and arrangements outside the normal course of business, as discussed above?

E. DOMINANT PARTIES

27. At the September meeting, the IAASB asked the task force to clarify the definition of dominant influence and to provide further illustrative guidance to explain the meaning of a dominant party.
28. The task force noted that parties become dominant when they are able to impose their will on the entity unchallenged. Accordingly, the task force agreed to clarify the definition of dominant influence to reflect this defining characteristic of dominant parties. The task force also agreed to amend the definition to indicate that a dominant party may be a member of management or those charged with governance, or may have no official role within the entity (see paragraph 13(c)). Finally, in response to the above comments, the task force agreed to provide further guidance to illustrate circumstances in which dominant influence may be evidenced (see paragraph A20).

Matter for IAASB Consideration

- Q8. Does the IAASB agree with the revised definition of dominant influence and the additional

illustrative guidance regarding dominant parties?

F. ARM'S LENGTH ASSERTIONS

29. At the September meeting, the IAASB agreed that the proposed ISA should not deal with the issue of implicit arm's length assertions,² and that it should be left to individual jurisdictions to develop appropriate guidance for auditors to deal with such assertions.
30. It was also noted that, although related party transactions may take place at market prices that may be substantiated, the issue concerned more the risks pertaining to the other aspects of these transactions, such as their nature, terms and conditions. Accordingly, disclosures that related party transactions were consummated on arm's length terms give rise to significant risks. Further, it was noted that no related party transaction can be conducted at arm's length given the nature of related parties, and that it may be more appropriate to consider terms such as "normal market conditions."
31. In light of these comments, the task force agreed to amend the relevant requirements and guidance to avoid differentiating between explicit and implicit arm's length assertions. The task force has amended the definition of an arm's length transaction to indicate that such a transaction involves parties who are independent of each other (see paragraph 13(a)). The task force also agreed that it would be appropriate to treat arm's length disclosures as significant risks for the reasons stated above (see paragraph 23). Finally, in response to comments made at the September meeting, the task force agreed to clarify the requirement in paragraph 27 that if management makes an arm's length assertion in the financial statements, the auditor shall obtain sufficient appropriate audit evidence about the assertion.

Matter for IAASB Consideration

Q9. Does the IAASB agree with the revisions explained above regarding arm's length assertions?

G) WRITTEN REPRESENTATIONS

32. The proposed ISA requires the auditor to obtain written representations from management regarding, among other things, the completeness of related party information disclosed to the auditor. At the September meeting, it was noted that the interaction between the requirement to obtain written representations and the proposed guidelines to define a related party (see Issue A above) was unclear. In particular, it was unclear whether it was intended that these representations should cover only the related party relationships and transactions that are defined by the applicable financial reporting framework, or whether the representations should also include parties that bear the proposed common related party characteristics but which do not fall under the related party definitions of the framework.

² This issue arose because the EC's revised 4th and 7th Directives require the disclosure of related party transactions *not* conducted under normal commercial or market terms.

33. The task force's view is that the requirement to obtain written representations from management and, where appropriate, those charged with governance that they have disclosed to the auditor the identity of the entity's related parties and all its related party relationships and transactions should only apply *in the context of the applicable financial reporting framework*. This is because there will be significant practical difficulties in imposing upon management a related party definition that is for the auditor's internal use only. Even if this could be imposed, management would likely have significant difficulty providing the required representations because the entity's information systems may only be designed to identify relationships and transactions that meet the definitions in the framework. Accordingly, the task force has clarified the requirement to obtain written representations to that effect (see paragraph 29).

Matter for IAASB Consideration

Q10. Does the IAASB agree that the requirement to obtain written representations should be limited to the context of the applicable financial reporting framework?

H) RELATED PARTIES IN THE CONTEXT OF A GROUP AUDIT

34. At the September CAG meeting, CAG representatives considered the extent of the work the auditor should perform on a component's related party relationships and transactions in the context of a group audit. They noted that while the group auditor would have to obtain an understanding of management's process for eliminating intra-group transactions at the consolidated level to assess the risks of material misstatement on consolidation, the component auditor would have to evaluate whether intra-group transactions have been appropriately accounted for and disclosed at the component level in accordance with the requirements of the financial reporting framework used for group reporting purposes.
35. The task force acknowledged that it is unclear whether current practice is consistent regarding the audit of intra-group transactions at the component level for group reporting purposes. The task force also noted that the latest draft of the proposed revised ISA 600, "The Audit of Group Financial Statements," does not provide much guidance on this issue. The task force agreed that where a component within a group is subject to a statutory audit, the requirements of the proposed ISA should apply in their entirety. However, for group reporting purposes, the task force believes that intra-group transactions do give rise to other implications at the component level, such as transfer pricing tax risks and fraud risks, even though these transactions should eliminate on consolidation.
36. Accordingly, subject to the task force giving the issue further consideration, the task force is of the view that all the requirements in the proposed ISA (except that relating to communication with those charged with governance) should apply in the audit of a component's consolidation returns for group reporting purposes. Pending further input from the IAASB, the task force has not included any guidance on this issue in the revised draft now being presented.

Matter for IAASB Consideration

Q11. What are the IAASB's views regarding the extent of work that a component's auditor should perform on the component's related party relationships and transactions (including intra-group) for group reporting purposes?

Material Presented

Agenda Item 9-A Revised Draft of the Proposed Revised ISA 550 (Clean)
(Pages 3187 – 3206)

Agenda Item 9-B Revised Draft of the Proposed Revised ISA 550 (Mark-up)
(Pages 3207 – 3232)

Draft of the ISA to be Discussed at the Meeting

The task force proposes that the **mark-up** version of the revised draft (**Agenda Item 9-B**) be discussed at the meeting.

Action Requested

The IAASB is asked to provide the task force with feedback and guidance on the significant issues noted above, and on the revised draft of the ISA.

APPENDIX

Categories of Auditor’s Responsibilities Regarding Related Parties and Relevant Requirements

[Cross-references to paragraph numbers in the revised draft are in square brackets]

	Auditor’s Responsibilities³		
	Compliance with the Specific Accounting and Disclosure Requirements of the FRF	Other Accounting Implications (Stand-back Test)	Responsibilities Relating to Fraud
Purpose of Auditor’s Procedures	To identify and assess the risks of material misstatement due to error in the context of the accounting and disclosure requirements of the applicable financial reporting framework	To evaluate whether the financial statements, as a whole, do not achieve fair presentation, or are misleading, because they do not appropriately reflect the economic reality of transactions and arrangements with RPs	To identify fraud risk factors relevant to the identification and assessment of the risks of material misstatement due to fraud
Requirements	<ul style="list-style-type: none"> • Team discussion [15(a)] • Inquire of management to understand who the RPs are that management has identified and what RPTs occurred during the period [16(a)-(c)] • Understand the controls that management has implemented to comply with the framework requirements [17(a)] 	<ul style="list-style-type: none"> • Team discussion [15 last sentence] • Understand the controls management has implemented to authorize and approve transactions and arrangements that are outside of the normal course of business [17(b)] 	<ul style="list-style-type: none"> • Team discussion [15(b)] • Understand the controls management has implemented to authorize and approve transactions and arrangements that are outside of the normal course of business [17(b)]

³ Note: procedures that are identified as being primarily targeted at one of the auditor’s related party responsibilities may also be relevant to other responsibilities.

	Auditor’s Responsibilities³		
	Compliance with the Specific Accounting and Disclosure Requirements of the FRF	Other Accounting Implications (Stand-back Test)	Responsibilities Relating to Fraud
	<ul style="list-style-type: none"> • Share relevant RP information with the team [19] • Maintain alertness to new RP information throughout the audit. Inspect certain documents. Investigate if circumstances indicate previously unidentified or undisclosed related parties. [20] • Evaluate whether significant RPTs have been accounted for in accordance with management’s explanations and obtain evidence of 	<ul style="list-style-type: none"> • Inquire about the general nature and business rationale of any significant transactions and arrangements identified that are outside of the normal course of business (as identified when performing ISA 315 and 240 risk assessment procedures) and whether they involve “related parties”. [18] • Share relevant RP information with the team [19] • Maintain alertness to new RP information throughout the audit. Inspect certain documents. Investigate if circumstances indicate previously unidentified or undisclosed related parties. [20] • Evaluate whether significant RPTs have been accounted for in accordance with management’s explanations, and obtain evidence of authorization and 	<ul style="list-style-type: none"> • Inquire about the general nature and business rationale of any significant transactions and arrangements identified that are outside of the normal course of business (as identified when performing ISA 315 and 240 risk assessment procedures) and whether they involve “related parties”. [18] • Share relevant RP information with the team [19] • Maintain alertness to new RP information throughout the audit. Inspect certain documents. Investigate if circumstances indicate previously unidentified or undisclosed related parties. [20] • Evaluate whether significant RPTs have been accounted for in accordance with management’s explanations, and obtain evidence of

	Auditor's Responsibilities³		
	Compliance with the Specific Accounting and Disclosure Requirements of the FRF	Other Accounting Implications (Stand-back Test)	Responsibilities Relating to Fraud
	authorization and approval [26] <ul style="list-style-type: none"> • Written representations on complete disclosure of RP relationships and transactions [29] • Evaluate whether accounting and disclosure of RP relationships and transactions are in accordance with the financial reporting framework [28(a)] 	approval [26] <ul style="list-style-type: none"> • Specific written representations, as deemed necessary, on accounting for RPTs to reflect their economic reality [29] • Apply stand-back test [28(b)] 	authorization and approval [26] <ul style="list-style-type: none"> • Specific written representations, as deemed necessary, on accounting for RPTs to reflect their economic reality [29]

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