

**PROPOSED INTERNATIONAL STANDARD ON AUDITING 550 (REVISED)****RELATED PARTIES****[Clean]**

(Effective for audits of financial statements for periods beginning on or after [date])

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## Introduction

### Scope of this ISA

1. This International Standard on Auditing (ISA) deals with the auditor's responsibilities regarding related party relationships and transactions when performing an audit of financial statements. Specifically, it expands on how ISA 315 (Redrafted), "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment," ISA 330 (Redrafted), "The Auditor's Responses to Assessed Risks," and ISA 240 (Redrafted), "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements," are to be applied in relation to risks of material misstatement resulting from related parties.

### *Nature of Related Party Relationships and Transactions*

2. Many related party transactions are in the normal course of business. In such circumstances, they may carry no higher risk of material misstatement of the financial statements than similar transactions with unrelated parties. (Ref: Para. A1)
3. However, the nature of related party relationships and transactions may, in some circumstances, give rise to higher risks of material misstatement of the financial statements than transactions with unrelated parties. For example:
  - Related parties may operate through an extensive and complex range of relationships and structures, and may enter into complex transactions.
  - Information systems may be ineffective at identifying or summarizing transactions and outstanding balances between an entity and its related parties, especially in entities where there are relationships and transactions involving family members of management that are not fully documented or formally approved.
  - Related party transactions may not be conducted under normal market terms and conditions; for example, some related party transactions may be conducted with no exchange of consideration.

### *Responsibilities of the Auditor*

4. An auditor conducting an audit in accordance with ISAs is responsible for obtaining reasonable assurance that the financial statements taken as a whole are free from material misstatement, whether caused by fraud or error.
5. Because related parties are not entirely independent of each other, many financial reporting frameworks establish specific disclosure requirements for related party relationships, transactions and balances to enable users of the financial statements to understand their nature and actual or potential effects on the financial statements. Where the applicable financial reporting framework establishes such requirements, the auditor has a responsibility to perform procedures to identify, assess and respond to the risks of material misstatement due to error arising from the entity's failure to appropriately account for or disclose related party relationships, transactions or balances in accordance with the requirements of the framework. (Ref: Para. A4)

6. Even if the applicable financial reporting framework establishes minimal or no related party requirements, the auditor nevertheless needs to obtain an understanding of the entity's related party relationships and transactions sufficient to be able to form the auditor's opinion, in accordance with [proposed] ISA 700 (Redrafted), "The independent Auditor's Report on General Purpose Financial Statements," on whether the financial statements:
- (a) Achieve fair presentation (for fair presentation frameworks); or (Ref: Para. A2)
  - (b) Are not misleading (for compliance frameworks). (Ref: Para. A3) **[ISSUE A]**
7. In addition, an understanding of the entity's related party relationships and transactions is relevant to the auditor's identification of fraud risk factors in accordance with ISA 240 (Redrafted), because fraud may be more easily committed through related parties.
8. As described in [proposed] ISA 200 (Revised), ["Overall Objective of the Independent auditor, and [Fundamental] Concepts Relevant to an Audit of Financial Statements,"] owing to the inherent limitations of an audit, 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.
9. In the context of related parties, inherent limitations regarding the auditor's ability to detect material misstatements are greater for a number of reasons, such as the following:
- Management may be unaware of the existence of all related party relationships and transactions.
  - Related party relationships may present a greater opportunity for collusion, concealment or manipulation by management.
10. Maintaining an attitude of professional skepticism throughout the audit as required by [proposed] ISA 200 (Revised) is therefore particularly important in this context, given the potential for undisclosed related party relationships and transactions. The requirements in this 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.

### Effective Date

11. This ISA is effective for audits of financial statements for periods beginning on or after [date].<sup>1</sup>

### Objectives

12. The objectives of the auditor are:
- (a) To obtain sufficient appropriate audit evidence about whether related party relationships and transactions have been appropriately accounted for and disclosed in accordance with the applicable financial reporting framework;

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<sup>1</sup> This date will not be earlier than December 15, 2008.

- (b) To obtain an understanding of related party relationships and transactions sufficient to be able to form the auditor's opinion on whether the financial statements:
  - (i) Achieve fair presentation (for fair presentation frameworks); or
  - (ii) Are not misleading (for compliance frameworks); and **ISSUE A]**
- (c) To identify fraud risk factors arising from related party relationships and transactions that are relevant to the identification and assessment of the risks of material misstatement due to fraud.

## Definitions

13. For purposes of the ISAs, the following terms have the meanings attributed below:

- (a) "Arm's length transaction" – A transaction conducted on such terms and conditions as between a willing buyer and a willing seller acting independently of each other and pursuing their own best interests;
- (b) "Dominant influence" – Domination of the entity by a single individual or small group of individuals allowing them to impose their will on the significant decisions affecting the entity's business. Such an individual or group of individuals may form part of management or those charged with governance, or may have no official role within the entity; and
- (c) "Related Party" – A party that has the ability to control or significantly influence, directly or indirectly through one or more intermediaries, the entity (or vice versa), or that is under common control with the entity. The applicable financial reporting framework may provide more specificity regarding the nature of related parties. (Ref: Para. A1)

## Requirements

### Risk Assessment Procedures and Related Activities

14. As part of the risk assessment procedures and related activities required by ISA 315 (Redrafted), the auditor shall perform the procedures and related activities set out in paragraphs 15 to 21 in order to obtain information relevant to identifying the risks of material misstatement resulting from related parties. (Ref: Para. A5)

### *Understanding the Entity's Related Party Relationships and Transactions*

15. The discussion among members of the engagement team required by ISAs 315 (Redrafted) and 240 (Redrafted) shall include specific consideration of the susceptibility of the financial statements to material misstatements due to fraud or error that could result from the entity's related party relationships and transactions. (Ref: Para. A6-A7)
16. In obtaining an understanding of the nature of the entity as required by ISA 315 (Redrafted), the auditor shall discuss with management:
- (a) The identity of the parties:
    - (i) That control or significantly influence the entity; and

- (ii) That the entity controls or significantly influences; and
  - (b) The nature of any business undertakings between the entity and these parties. **[ISSUE B]**
- 17. If the applicable financial reporting framework establishes related party requirements, the auditor shall also obtain from management the names of the related parties that management has identified to meet those requirements, and inquire of management regarding: (Ref: Para. A8)
  - (a) The nature of the relationships between the entity and these related parties; and
  - (b) Whether the entity entered into any transactions with these related parties during the period, and if so, the general nature of these transactions. **[ISSUE B]**
- 18. Through inquiries of management and others within the entity, or by performing other procedures considered appropriate, the auditor shall obtain an understanding of the controls that management has established to: (Ref: Para. A9-A13, A15)
  - (a) Identify, account for, and disclose related party relationships and transactions in accordance with the applicable financial reporting framework; and
  - (b) Authorize and approve transactions and arrangements outside the normal course of business. (Ref: Para. A14)
- 19. The auditor shall share relevant information obtained about the entity's related party relationships with the other members of the engagement team.

*Maintaining Alertness for Related Party Information When Performing the Audit*

- 20. If, during the course of the audit, the auditor identifies significant transactions outside the normal course of business, the auditor shall inquire of management to understand:
  - (a) The nature of these transactions and their business rationale; and
  - (b) Whether such transactions involve related parties. (Ref: Para. A16)
- 21. The auditor shall also be alert for arrangements or other information that may indicate the existence of related party relationships or transactions that management has not previously identified or disclosed to the auditor. In addition, the auditor shall inspect the following documents for information that may indicate the existence of such relationships and transactions:
  - (a) Bank and legal confirmations obtained as part of the auditor's procedures; and
  - (b) Minutes of meetings of shareholders and of those charged with governance. (Ref: Para. A17-A18)

If the auditor identifies such information, the auditor shall perform appropriate procedures to determine whether the underlying circumstances reveal the existence of related parties that management has not previously identified or disclosed to the auditor.

## **Identification and Assessment of the Risks of Material Misstatement Resulting from Related Parties**

22. If, in carrying out the risk assessment procedures and related activities in relation to related parties, the auditor identifies fraud risk factors (including circumstances relating to the existence of a dominant party), the auditor shall consider such information when identifying and assessing the risks of material misstatement due to fraud in accordance with ISA 240 (Redrafted). (Ref: Para. A19-A21)
23. In identifying and assessing the risks of material misstatement as required by ISA 315 (Redrafted), the auditor shall treat at least the following as circumstances giving rise to significant risks:
  - Identified significant related party transactions outside the normal course of business.
  - Management has made an explicit assertion in the financial statements stating that a related party transaction was conducted on terms equivalent or similar to those prevailing in an arm's length or market transaction. (Ref: Para. A22-A23) **ISSUE C]**

## **Responses to the Risks of Material Misstatement Resulting from Related Parties**

24. As part of the responses to assessed risks required by ISA 330 (Redrafted), the auditor shall design and perform further audit procedures that are responsive to the assessed risks of material misstatement resulting from related parties. These procedures shall include those required by paragraphs 25-27. (Ref: Para. A24-A27)

### *Identification of Previously Unidentified or Undisclosed Related Parties or Significant Related Party Transactions*

25. If, when the applicable financial reporting framework establishes related party requirements, the auditor identifies related parties or significant related party transactions that management has not previously identified or disclosed to the auditor, the auditor shall:
  - (a) Promptly communicate any newly identified related parties to the other members of the engagement team to enable them to determine whether this information affects the results of, and conclusions drawn from, audit procedures already performed, including whether the risks of material misstatement need to be reassessed;
  - (b) Request management to identify all transactions with the newly identified related parties for the auditor's further evaluation;
  - (c) Inquire as to why the entity's controls over related party relationships and transactions failed to enable the identification or disclosure of the related party relationships or transactions;
  - (d) Perform appropriate substantive procedures to respond to risks relating to such newly identified related parties or significant related party transactions; and (Ref: Para. A28)
  - (e) If the non-identification or non-disclosure appears intentional, (i) communicate this information to those charged with governance (unless all of them are part of management), and (ii) evaluate the implications on the audit. (Ref: Para. A29)

*Identified Significant Related Party Transactions Outside the Normal Course of Business*

26. For identified significant related party transactions outside the normal course of business, the auditor shall:
- (a) When evaluating the business rationale of the transactions as required by ISA 240 (Redrafted), evaluate whether their terms and the way they have been accounted for are consistent with management's explanations; and (Ref: Para. A30-A31)
  - (b) Obtain evidence that they have been authorized and approved. (Ref: Para. A32-A33)

*Explicit Assertions that Related Party Transactions were Conducted on Terms Equivalent or Similar to Arm's Length or Market Transactions*

27. When management has made an explicit assertion in the financial statements stating that a related party transaction was conducted on terms equivalent or similar to those prevailing in an arm's length or market transaction, the auditor shall obtain sufficient appropriate audit evidence about the assertion. If the auditor is unable to obtain sufficient appropriate audit evidence about the assertion, the auditor shall request management to delete or correct the assertion as appropriate. If management disagrees, the auditor shall consider the implications on the audit, including on the auditor's report. (Ref: Para. A34-A36)

**Evaluation of the Accounting for and Disclosure of Identified Related Party Relationships and Transactions**

28. In forming the opinion on the financial statements, the auditor shall evaluate:
- (a) Whether the identified related party relationships and transactions have been appropriately accounted for and disclosed in accordance with the applicable financial reporting framework; and
  - (b) Whether the related party relationships and transactions could cause the financial statements to:
    - (i) Fail to achieve fair presentation (for fair presentation frameworks); or
    - (ii) Be misleading (for compliance frameworks). (Ref: Para. A37-A38)

**Written Representations**

29. In addition to any specific written representations the auditor believes are necessary in relation to related parties, the auditor shall, where the applicable financial reporting framework establishes related party requirements, obtain written representations from management and, where appropriate, those charged with governance that:
- (a) They have disclosed to the auditor the identity of the entity's related parties and all the related party relationships and transactions of which they are aware; and
  - (b) They have appropriately accounted for and disclosed such relationships and transactions in accordance with the requirements of the framework. (Ref: Para. A39)

## **Communication with Those Charged with Governance**

30. Unless all of those charged with governance are involved in managing the entity, the auditor shall communicate with them significant matters identified during the audit regarding the entity's related party relationships and transactions. (Ref: Para. A40)

## **Documentation**

31. The auditor shall include in the audit documentation the names of the identified related parties and, unless otherwise clear, the nature of the related party relationships.

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## **Application and Other Explanatory Material**

### **Nature of Related Party Relationships and Transactions** (Ref: Para. 2, 13(c))

- A1. Many financial reporting frameworks include related party definitions that are adequate for the purposes of this ISA. These definitions are ordinarily set out in terms of relationships involving control or significant influence. Where the applicable financial reporting framework establishes minimal or no related party definitions, the following characteristics generally indicate the existence of related party relationships:
- (a) Equity or other financial interests of a party in the entity (or vice versa) that lead to control or significant influence.
  - (b) The entity is under common control with another party, such as through having common management or a common controlling shareholder.
  - (c) The ability to directly exert influence over the entity by being part of the management or those charged with governance of the entity.
  - (d) The ability to indirectly exert influence over the entity by being a close family member of any individual referred to in subparagraph (c).
  - (e) The ability to indirectly exert influence over the entity by virtue of a business relationship with any individual referred to in subparagraph (c).

### **Responsibilities of the Auditor** (Ref: Para. 5-6)

- A2. In the context of a fair presentation framework, related party relationships and transactions may cause the financial statements to fail to achieve fair presentation if, for example, the economic reality of such relationships and transactions is not appropriately reflected in the financial statements. For instance, fair presentation would not be achieved if the sale of a property by the entity to a controlling shareholder at a price above or below fair market value has been accounted for as a transaction involving a profit or loss for the entity when, in reality, it constitutes a contribution or return of capital or the payment of a dividend.
- A3. In the context of a compliance framework, related party relationships and transactions may cause the financial statements to be misleading to users in the particular circumstances of the engagement. For example, the financial statements may be prepared for the benefit of a third party who is contemplating acquiring a significant equity stake in the entity at a price that is



premised on the entity's ability to continue as a going concern. The financial statements may be regarded as misleading in these circumstances if the entity's status as a going concern depends largely on the financial support of one or more related parties, and that fact is not disclosed. As [proposed] ISA 700 (Redrafted) indicates, however, cases in which financial statements prepared in accordance with a compliance framework are regarded as misleading in the circumstances are expected to be extremely rare.

#### Considerations Specific to Public Sector Entities

- A4. The public sector auditor's responsibilities regarding related party relationships and transactions may be affected by the audit mandate, or by obligations on public sector entities arising from legislation, regulation, ministerial directives, government policy requirements, or resolutions of the legislature. Consequently, the public sector auditor's responsibilities may not be limited to addressing the risks of material misstatement resulting from related parties, but may also include a broader responsibility to address the risks of non-compliance with laws and regulations governing public sector bodies that lay down specific requirements in the conduct of business with related parties. Further, the public sector auditor may need to have regard to public sector financial reporting requirements for related party relationships and transactions that may differ from those in the private sector.

#### **Risk Assessment Procedures and Related Activities** (Ref: Para. 14)

- A5. Risk assessment procedures and related activities that the auditor performs in accordance with ISA 315 (Redrafted) provide information that is relevant to identifying the risks of material misstatement resulting from related parties. For example, risk assessment procedures to obtain an understanding of:

- The entity's ownership and governance structures;
- The types of investments that the entity is making and plans to make; and
- The way the entity is structured and how it is financed

provide insight into how the entity is controlled or significantly influenced, how it controls or significantly influences other parties, and whether it is under common control with other parties. Such procedures and related activities include, but are not limited to, inquiries of management and others within the entity.

#### *Understanding the Entity's Related Party Relationships and Transactions*

##### Discussion among the Engagement Team (Ref: Para. 15)

- A6. Matters that may be addressed in the discussion among the engagement team include:
- The nature and extent of the entity's relationships and transactions with related parties.
  - An emphasis on the importance of maintaining an attitude of professional skepticism throughout the audit regarding the potential for material misstatement resulting from related parties.
  - The circumstances or conditions of the entity that may indicate the existence of related party relationships or transactions that management has not identified or disclosed to the

auditor (for example, a complex organizational structure or an inadequate information system).

- The importance that management and those charged with governance attach to the identification, appropriate accounting for, and disclosure of related party relationships and transactions (if the applicable financial reporting framework establishes related party requirements), and the related risk of management override of relevant controls.

A7. In addition, the discussion in the context of fraud may include specific consideration of how related parties may be involved in fraud. For example:

- A consideration of circumstances that might indicate earnings management that could result in fraudulent financial reporting may include consideration of how special purpose entities controlled by management might be used to facilitate earnings management.
- A consideration of transactions between the entity and a known business partner of a key member of management may include consideration of how the transactions could be arranged to facilitate misappropriation of the entity's assets.

**Inquiries and Other Risk Assessment Procedures (Ref: Para. 17-18)**

A8. The auditor may also obtain some information regarding the identity of the entity's related parties through inquiries of management during the engagement acceptance or continuance process.

A9. Others within the entity are those considered likely to have knowledge of the entity's related party relationships and transactions. These may include, to the extent that they do not form part of management:

- Those charged with governance;
- Personnel in a position to initiate, process, or record transactions that are both significant and outside the normal course of business, and those who supervise or monitor such personnel;
- Internal audit;
- In-house legal counsel; and
- The chief ethics officer or equivalent person.

A10. As [proposed] ISA 200 (Revised) explains, the audit is conducted on the premises that management and, where appropriate, those charged with governance acknowledge and understand their responsibility for:

- Preparing and presenting the financial statements in accordance with the applicable financial reporting framework; and
- Designing, implementing and maintaining internal control relevant to the preparation and presentation of financial statements that are free from material misstatement, whether due to fraud or error.

Accordingly, where the framework establishes related party requirements, management, with oversight from those charged with governance, is responsible for designing, implementing and maintaining adequate controls over related party relationships and transactions so that these are identified and appropriately accounted for and disclosed in accordance with the framework. In their oversight role, those charged with governance are responsible for monitoring how management is discharging its responsibility for such controls. Irrespective of the extent to which the applicable financial reporting framework establishes related party requirements, those charged with governance need to obtain from management information to enable them to understand the nature and business rationale of the entity's related party relationships and transactions to the extent necessary to fulfill their oversight responsibilities.

A11. In obtaining an understanding of the control environment in accordance with ISA 315 (Redrafted), the auditor may consider features of the control environment relevant in mitigating the risks of material misstatement resulting from related parties, such as:

- Internal ethical codes, appropriately communicated to the entity's personnel and enforced, governing the circumstances in which the entity may enter into specific types of related party transactions.
- Policies and procedures for open and timely disclosure of the interests that management and those charged with governance have in related party transactions.
- The assignment of responsibilities within the entity for identifying, recording, summarizing, and disclosing related party transactions.
- Timely disclosure and discussion between management and those charged with governance of significant related party transactions outside the normal course of business, including whether those charged with governance have appropriately challenged the business rationale of such transactions (for example, by seeking advice from external professional advisors).
- Clear guidelines for the approval of related party transactions involving actual or perceived conflicts of interest, such as approval by a subcommittee of those charged with governance comprising individuals independent of management.
- Periodic reviews by internal audit, where applicable.
- Proactive action taken by management to resolve related party disclosure issues, such as by seeking advice from the auditor or external legal counsel.
- The existence of whistle-blowing policies and procedures, where applicable.

A12. Controls over related party relationships and transactions within some entities may be weak, ineffective or non-existent for a number of reasons, such as:

- The low importance attached by management to identifying and disclosing related party relationships and transactions.
- The lack of appropriate oversight by those charged with governance.

- An intentional disregard for such controls because related party disclosures may reveal information that management considers sensitive.
- An insufficient understanding by management of the related party requirements of the applicable financial reporting framework.
- The absence of disclosure requirements under the applicable financial reporting framework.

Where such controls are ineffective or non-existent, the auditor may be unable to obtain sufficient appropriate audit evidence about related party relationships and transactions. This may be particularly the case in larger, more complex entities.

A13. As discussed in ISA 240 (Redrafted), fraudulent financial reporting and misappropriation of assets often arise through management override of controls that otherwise appear to be operating effectively. The risk of management override of controls is higher if management has related party relationships with parties with which the entity does business because these relationships may present management with greater incentives and opportunities to perpetrate fraud. For example, management's financial interests in certain related parties may provide incentives for management to override controls by (a) directing the entity, against its interests, to conclude transactions benefiting the related parties, or (b) colluding with those parties or controlling their actions. Examples of possible fraud include:

- Creating fictitious terms of transactions with related parties designed to misrepresent the business rationale of these transactions.
- Fraudulently organizing the transfer of assets from or to management or others at amounts significantly above or below market value.
- Engaging in complex transactions with related parties, such as special-purpose entities,<sup>2</sup> that are structured to misrepresent the financial position or financial performance of the entity.

A14. Examples of controls the entity may have established to authorize and approve transactions and arrangements outside the normal course of business include:

- Monitoring controls to identify such transactions and arrangements for authorization and approval.
- Approval of the terms and conditions of the transactions and arrangements by management and those charged with governance, and, where applicable, shareholders.
- The completion of documentary procedures to evidence formal authorization and approval, such as signed minutes of meetings at which the transactions and arrangements were approved.

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<sup>2</sup> Special-purpose entities (sometimes referred to as structured finance entities) are entities that are established for specific limited purposes, such as providing financing, liquidity, hedging or credit support.

### Considerations Specific to Smaller Entities

A15. As discussed in ISA 315 (Redrafted), the control environment in small entities is likely to be different from that in larger entities. In particular, those charged with governance in small entities may not include an independent or outside member, and the role of governance may be undertaken directly by the owner-manager where no other owners exist. Consistent with their simpler businesses, smaller entities may have fewer or no processes in place for dealing with related party relationships and transactions. Instead, the owner-manager in a small business may mitigate some of the risks that may arise from related party transactions through active involvement in all the main aspects of the transactions. Accordingly, for such entities, the auditor may only be able to obtain an understanding of the related party relationships and transactions through inquiry of management.

### *Maintaining Alertness for Related Party Information When Performing the Audit* (Ref: Para. 20-21)

A16. Examples of transactions outside the normal course of business include:

- Complex equity transactions, such as corporate restructurings or acquisitions.
- Transactions with offshore entities in jurisdictions with weak corporate laws.
- The leasing of premises or the rendering of management services by the entity to another party if no consideration is exchanged.
- Sales transactions with unusually large discounts or returns.
- Transactions with circular arrangements, for example, sales with a commitment to repurchase.
- Contracts whose terms are changed before expiry.

A17. Examples of arrangements that may indicate the existence of related party relationships or transactions that management has not previously identified or disclosed to the auditor include:

- Guarantees and guarantor relationships.
- Special-purpose entities.

A18. The auditor may also inspect some or all of the following records or documents in the course of performing other audit procedures, which may provide new information about related party relationships and transactions:

- Third party confirmations (in addition to bank and legal confirmations).
- Entity income tax returns.
- Information supplied to regulatory authorities.
- Shareholder registers to identify the entity's principal shareholders.
- Statements of conflicts of interest from management and those charged with governance.
- Records of the entity's investments and those of its pension plans.
- Specific significant contracts and agreements not in the ordinary course of business,

including those involving management and those charged with governance.

- Specific invoices and correspondence from professional advisors.
- Life insurance policies acquired by the entity.
- Significant contracts re-negotiated during the period.
- Internal audit working papers.
- Records or documents associated with a public offering of the entity's securities (for example, prospectuses).

**Identification and Assessment of the Risks of Material Misstatement Resulting from Related Parties** (Ref: Para. 22-23)

A19. Risks of material misstatement resulting from related parties generally arise from one or more of the following circumstances:

- Management has not identified or disclosed to the auditor one or more of the entity's related parties.
- Management has not identified or disclosed to the auditor relationships and transactions with identified related parties.
- Management has not appropriately accounted for or disclosed identified related party relationships or transactions in accordance with the applicable financial reporting framework.

A20. The existence of a party with dominant influence over the entity is a risk factor on its own because such a party has the ability to impose its will on the entity. This type of influence arises mainly from the party's significant direct or indirect majority control over the entity, and may be evidenced in such ways as the following:

- The dominant party has vetoed significant business decisions taken by management or those charged with governance.
- All significant transactions are referred to the dominant party for final approval.
- There is little or no debate among management and those charged with governance regarding business proposals initiated by the dominant party.
- Transactions involving the dominant party are not independently reviewed and approved.

The dominant party's influence may be greater in some cases if that party has played a leading role in founding the entity and continues to play a leading role in managing the entity.

A21. In the presence of other risk factors, the existence of a dominant party may indicate significant risks of material misstatement due to fraud. For example:

- An unusually high turnover of senior management or professional advisors may suggest unethical or fraudulent business practices that serve the dominant party's purposes.
- The use of business intermediaries for significant transactions for which there appears to

- be no clear business justification may suggest that the dominant party could have an interest in such transactions through control of such intermediaries for fraudulent purposes.
- Evidence of the dominant party's excessive participation in or preoccupation with the selection of accounting policies or the determination of significant estimates may suggest the possibility of fraudulent financial reporting.

A22. Although evidence may be readily available regarding how the price of a related party transaction compares to that of an arm's length or market transaction, there are ordinarily practical difficulties that limit the auditor's ability to obtain evidence that all other aspects of the transaction are equivalent or similar to those of an arm's length or market transaction. For example, although the auditor may be able to confirm that a related party transaction has been conducted at a market price, it may be impracticable to confirm whether other terms and conditions of the transaction (such as credit terms, contingencies and specific charges) are equivalent to those that would ordinarily be agreed between independent parties. Accordingly, there is a significant risk that management's explicit assertion that a related party transaction was conducted on terms equivalent or similar to those prevailing in an arm's length or market transaction may be materially misstated.

A23. Management may also make an implicit assertion regarding the arm's length nature of a related party transaction by not disclosing the transaction in the financial statements if the applicable financial reporting framework requires the disclosure of those related party transactions that were not conducted on terms equivalent or similar to those prevailing in arm's length or market transactions. In such a case, determining whether the entity has complied with the disclosure requirements of the framework involves considering how sufficient appropriate audit evidence may be obtained that related party transactions that have not been disclosed in the financial statements have been conducted on terms equivalent or similar to those prevailing in arm's length or market transactions. **[ISSUE C]**

**Responses to the Risks of Material Misstatement Resulting from Related Parties** (Ref: Para. 24)

A24. The nature, timing and extent of the further procedures that the auditor may select to respond to the assessed risks of material misstatement resulting from related parties depend upon the nature of those risks and the circumstances of the entity. ISA 330 (Redrafted) provides further guidance on considering the nature, timing and extent of further audit procedures. ISA 240 (Redrafted) establishes requirements and provides guidance on appropriate responses to assessed risks of fraud.

A25. Examples of substantive procedures that the auditor may perform when the auditor has assessed a significant risk that management has not appropriately accounted for or disclosed specific related party transactions in accordance with the applicable financial reporting framework (whether due to fraud or error) include:

- Confirming or discussing specific aspects of the transactions with intermediaries such as banks, law firms, guarantors, or agents, where practicable and not prohibited by law, regulation or ethical rules.

- Confirming the purposes, specific terms or amounts of the transactions with the related parties (this procedure may be less effective where the auditor judges that the entity is likely to influence the related parties in their responses to the auditor).
- Where applicable, reading the financial statements or other relevant financial information, if available, of the related parties for evidence of the accounting of the transactions in the related parties' books.

A26. If the auditor has assessed a significant risk of material misstatement due to fraud as a result of the presence of a party with dominant influence over the entity, the auditor may, in addition to the general requirements of ISA 240 (Redrafted), perform procedures such as the following to obtain an understanding of the business relationships that such a dominant party may have established directly or indirectly with the entity and to determine the need for further appropriate substantive procedures:

- Inquiries of, and discussion with, management and those charged with governance.
- Inquiries of the dominant party.
- Inspection of significant contracts with the dominant party.
- Appropriate background research, such as through the Internet or specific external business information databases.
- Review of the entity's whistle-blowing records, where available.

A27. In some circumstances, it may not be possible to obtain sufficient appropriate audit evidence only from substantive procedures in relation to the risks of material misstatement resulting from related parties. For example, where intra-group transactions between the entity and its components are numerous and a significant amount of information regarding these transactions is initiated, recorded, processed or reported electronically in an integrated system, the auditor may determine that it is not possible to design effective substantive procedures that by themselves would reduce the risks of material misstatement resulting from these transactions to an acceptably low level. In these circumstances, it may be necessary to test the entity's controls over the completeness and accuracy of the recording of related party relationships and transactions in order to obtain sufficient appropriate audit evidence.

*Identification of Previously Unidentified or Undisclosed Related Parties or Significant Related Party Transactions (Ref: Para. 25)*

A28. Examples of substantive procedures that the auditor may perform to respond to risks relating to newly identified related parties or significant related party transactions include:

- Making inquiries regarding the nature of the entity's relationships with the newly identified related parties, including (where appropriate and not prohibited by law, regulation or ethical rules) inquiring of parties outside the entity who are presumed to have significant knowledge of the entity and its business, such as principal agents, major representatives, consultants, guarantors, or other close business partners.
- Conducting an analysis of accounting records for transactions with the newly identified



related parties. Such an analysis may be facilitated using computer-assisted audit techniques.

- Verifying the terms and conditions of the newly identified related party transactions, and evaluating whether the transactions have been accounted for in accordance with the applicable financial reporting framework.

A29. If management appears to have intentionally failed to disclose related parties or significant related party transactions to the auditor, this may indicate a significant risk of fraud. The requirements and guidance in ISA 240 (Redrafted) regarding the auditor's responsibilities relating to fraud in an audit of financial statements are relevant in these circumstances. The auditor may also consider whether it is necessary to re-evaluate the reliability of management's responses to the auditor's inquiries and management's representations to the auditor.

*Identified Significant Related Party Transactions Outside the Normal Course of Business* (Ref: Para. 26)

A30. In evaluating the business rationale of a significant related party transaction outside the normal course of business, the auditor may consider the following:

- Whether the transaction:
  - Is overly complex (for example, it may involve multiple related parties within a consolidated group).
  - Has unusual terms of trade, such as unusual prices, interest rates, guarantees and repayment terms.
  - Lacks an apparent logical business reason for its occurrence.
  - Involves previously unidentified related parties.
  - Is processed in an unusual manner.
- Whether management has discussed the nature of, and accounting for, such a transaction with those charged with governance.
- Whether management is placing more emphasis on a particular accounting treatment rather than considering the underlying economics of the transaction.

A31. The auditor may also seek to understand the business rationale of such a transaction from the related party's perspective, as this may help the auditor to better understand the economic reality of the transaction and why it was carried out. A business rationale from the related party's perspective that appears inconsistent with the nature of its business may represent a risk factor.

A32. Authorization and approval by management, those charged with governance, or, where applicable, the entity's shareholders, of significant related party transactions outside the normal course of business may provide evidence that these have been duly considered at the appropriate levels within the entity and that their terms and conditions have been appropriately reflected in the financial statements. The existence of transactions of this nature that were not

subject to such authorization and approval, in the absence of rational explanations based on discussion with management and those charged with governance, may indicate risks of material misstatement due to error or fraud. Authorization and approval alone, however, may not be sufficient in concluding whether fraud risks are absent because authorization and approval may be ineffective if there has been collusion between the related parties or if the entity is subject to the dominant influence of another party.

#### Considerations Specific to Smaller Entities

A33. A smaller entity may not have the same compensating controls provided by different levels of authority and approval that may exist in a larger entity. Accordingly, when auditing a smaller entity, the auditor may rely to a lesser degree on authorization and approval for evidence regarding significant related party transactions outside the normal course of business.

#### *Explicit Assertions that Related Party Transactions were Conducted on Terms Equivalent or Similar to Arm's Length or Market Transactions* (Ref: Para. 27)

A34. Management is responsible for substantiating an assertion that a related party transaction was conducted on terms equivalent or similar to those of an arm's length transaction. Management's support for the assertion may include:

- Comparing the terms of the related party transaction to those of an identical or similar transaction with one or more unrelated parties.
- Engaging an external expert to determine a market value and to confirm market terms and conditions for the transaction.
- Comparing the terms of the transaction to known market terms for broadly similar transactions on an open market.

A35. Evaluating management's support for this assertion may involve one or more of the following:

- Considering the appropriateness of management's process for supporting the assertion.
- Verifying the source of the internal or external data supporting the assertion, and testing the data to determine their accuracy, completeness and relevance.
- Evaluating the reasonableness of any significant assumptions on which the assertion is based.

A36. A refusal by management to correct a material misstatement regarding an assertion that a related party transaction was conducted on terms equivalent or similar to those of an arm's length transaction, either by amending the relevant disclosure or by providing additional appropriate disclosures, may have implications on the audit, such as the reliability of the representations made by management, the assessment of fraud risks, consideration of the need to modify the audit opinion, and consideration of whether to withdraw from the engagement. The auditor may also find it appropriate to consult legal counsel.

**Evaluation of the Accounting for and Disclosure of Identified Related Party Relationships and Transactions** (Ref: Para. 28)*Materiality Considerations in Evaluating Misstatements*

A37. A consideration of both the size and nature of a related party transaction is important in evaluating whether a misstatement to which it gives rise is material, because:

- (a) The significance of the transaction may not depend solely on the recorded amount of the transaction but also on other specific relevant factors, such as the nature of the related party relationship (for example, the applicable financial reporting framework may deem transactions between the entity and those charged with governance to be significant regardless of the amounts involved); or
- (b) There may be no objective basis for measuring the transaction.

*Evaluation of Related Party Disclosures*

A38. Evaluating the entity's related party disclosures in the context of the disclosure requirements of the applicable financial reporting framework means considering whether the facts and circumstances of the entity's related party relationships and transactions have been appropriately summarized and presented so that the disclosures are understandable. Disclosures of related party transactions may not be understandable if:

- (a) The business rationale and the effects of the transactions on the financial statements are unclear or misstated; or
- (b) Key terms, conditions, or other important elements of the transactions necessary for understanding them are not appropriately disclosed.

**Written Representations** (Ref: Para. 29)

A39. Specific written representations may address, where appropriate, specific related party issues, such as the existence of undisclosed side agreements on significant related party transactions. Circumstances in which it may be appropriate to obtain written representations from those charged with governance include:

- When they have approved specific related party transactions that (a) materially affect the financial statements, or (b) involve management.
- When they have made specific oral representations to the auditor on details of certain related party transactions.
- When they have financial or other interests in the related parties or the related party transactions.
- When they are responsible for the financial statements.

**Communication with Those Charged with Governance** (Ref: Para. 30)

A40. Communicating significant related party matters identified during the audit with those charged with governance helps the auditor to establish a common understanding with them of the nature and resolution of these matters. This may also provide an opportunity for the auditor to

alert those charged with governance to significant related party relationships and transactions of which they may not have been previously aware. Examples of significant related party matters include:

- The identification of significant related party transactions that have not been appropriately authorized and approved, which may give rise to suspected fraud.
- Disagreement with management regarding the accounting for and disclosure of significant related party transactions in accordance with the applicable financial reporting framework.
- Difficulties in confirming the identity of the party that ultimately controls the entity.