

**ISSUES PAPER****Proposed ISA 550 (Revised and Redrafted), “Related Parties”****Introduction**

1. The comment period for the re-exposure draft of the proposed ISA 550 (Revised and Redrafted), “Related Parties,” (ED 550) closed on June 30, 2007. A total of 50 comment letters were received. A list of the respondents is included in Appendix A. (One respondent (IOSCO) submitted its comment letter after the task force had finalized its deliberations in preparing the papers for the December 2007 IAASB meeting. The task force will consider the comment letter at the December meeting and discuss any further matters arising from this submission that may require the IAASB’s consideration.)
2. Respondents were overall supportive of the revised draft, with many expressing the view that it was an improvement over the previous draft. Most of the respondents addressed the two specific questions posed in the explanatory memorandum (“EM”) regarding the proposed definition of a related party and the matter of implicit arm’s length assertions. Most of the significant comments focused on specific proposals in the requirements section. There were relatively fewer significant comments on the proposed guidance in the application material.
3. The following section summarizes the significant comments received from respondents (including responses to the two specific EM questions), and the task force’s preliminary views and recommendations.
4. At the September 2007 IAASB CAG meeting, CAG representatives discussed a number of the significant issues presented below. The CAG working group monitoring the project commented that, generally, the task force’s recommendations greatly improve the exposure draft. Significant comments from the CAG representatives have been included at appropriate places in the discussion below.

**Significant Comments****A. OBJECTIVES OF THE ISA**

5. In finalizing ED 550, the IAASB concluded that the objectives of the ISA should reflect the three distinct responsibilities of the auditor with respect to related parties, i.e.:
  - (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; and
  - (b) Irrespective of whether the applicable financial reporting framework establishes related party requirements:
    - (I) To obtain an understanding of related party relationships and transactions sufficient to be able to conclude whether the financial statements, insofar as they are affected by those relationships and transactions:
      - (i) Achieve fair presentation (for fair presentation frameworks); or

(ii) Are not misleading (for compliance frameworks); and

(II) 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.

6. There was clear overall support from the respondents for this approach to the objectives. Several respondents, however, offered suggestions for further improvement:
- A number of them (CIPFA, EY, FEE, ICAEW and IDW) suggested that the objectives would be clearer and their flow improved if the “obtaining an understanding” part were to be placed first because obtaining (or not obtaining) sufficient appropriate audit evidence depends upon the auditor first obtaining an understanding and assessing risk. Some CAG representatives, however, noted that an objective to conclude (i.e. part (b)(I) of the objectives) should not precede an objective to obtain sufficient appropriate audit evidence (part (a) of the objectives).
  - Three respondents (FEE, IDW and IRE) were of the view that the objectives should not include the phrase *“irrespective of whether the applicable financial reporting framework establishes related party requirements”* because a principles-based objective should not refer to a specific (series of) financial reporting framework(s). They were also of the view that the phrase was redundant because from a risk-based perspective, subparagraphs (I) and (II) of the objectives should always be met. The IAASB CAG working group, however, disagreed as it is of the view that the phrase provides an important reminder to the auditor that these objectives remain applicable even if the framework does not establish related party requirements.
  - Two respondents (DTT and ICAIre) suggested that subparagraph (b)(II) seemed to imply that the auditor would not meet the objectives of the ISA if no fraud risk factors were identified. Accordingly, they suggested that a more appropriate objective would be to respond to fraud risk factors that are identified.
  - Two other respondents (AICPA and NZICA) were of the view that greater recognition should be given to the identification of related party relationships and transactions in the objectives.
7. The IAASB CAG working group also expressed some concern about the emphasis on fraud risk in the objectives as opposed to other types of risk. Another CAG representative, however, took the view that related party transactions are a major source of risk that could lead to catastrophic fraud, and these should therefore receive the utmost attention.

#### *Preliminary Task Force Views and Recommendations*

8. The task force debated the suggestion as to whether it would be appropriate to place the “obtaining an understanding” part of the objectives first. The task force concluded that, on balance, no change should be made to the order of the objectives because, as suggested in the CAG discussions, it would be confusing to refer to forming a conclusion as to whether the financial statements achieve fair presentation or are not misleading, before an objective to obtain sufficient appropriate audit evidence regarding appropriate accounting and disclosure.

9. The task force also believes that the phrase “irrespective of whether the applicable financial reporting framework establishes related party requirements” should be retained as it appropriately emphasizes, in the particular context of this ISA, that the objectives in parts (b)(I) and (b)(II) apply regardless of what requirements the framework may specify. The task force did not believe that the inclusion of this phrase would undermine the framework neutrality of the ISA given that the phrase itself makes no reference to any specific framework.
10. With regard to the identification of fraud risk factors, the task force agreed, on further reflection, that the objective proposed in ED 550 (part (b)(II)) went further than what ISA 240 (Redrafted) currently requires,<sup>1</sup> because the latter does not require the auditor to identify fraud risk factors. The task force believes that the scope and extent of the requirements proposed in ED 550 are not sufficient in themselves to support an objective to *identify* all such risk factors. Such an objective could represent a potentially onerous and impracticable obligation. Accordingly, the task force concluded that a more appropriate objective would be for the auditor to obtain an understanding of related party relationships and transactions sufficient to be able to *recognize* fraud risk factors if they are present, consistent with ISA 240 (Redrafted). Finally, given that fraud risk factors may not be present in all circumstances, the task force agreed that the qualifying words “if any” should be added to this objective.
11. The task force did not agree that the ISA should include as one of its objectives the identification of related party relationships and transactions. The task force is of the view that, where the applicable financial reporting framework establishes related party requirements, the question of identification would be covered by whether related party relationships and transactions have been appropriately accounted for and disclosed in accordance with the framework, and *that* is the desired outcome that is reflected in the objectives. Notwithstanding this, many of the requirements in ED 550 (such as making relevant inquiries of management, probing into significant transactions outside the entity’s normal course of business, and maintaining heightened alertness) are geared towards identification as a pre-requisite step towards concluding on whether the higher-level objectives have been achieved.
12. Where the framework does not establish accounting and disclosure requirements for related parties, the task force is of the view that including identification as one of the objectives would set a virtually impossible task for the auditor as management itself may not have identified all parties that should be deemed related under this auditing standard. Furthermore, it is the recognition of fraud risk factors that is the key objective in those circumstances, rather than obtaining evidence about the completeness of the entity’s related parties. Whilst the auditor’s preliminary inquiries may be useful, the task force believes that it is (a) the focus on the entity’s controls over the authorization and approval of significant transactions outside the normal course of business, and (b) probing into the

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<sup>1</sup> ISA 240 (Redrafted), paragraph 24, requires the auditor to *evaluate* whether the information obtained from the other risk assessment procedures and related activities performed indicates that one or more fraud risk factors are present.

nature of such transactions when identified during the audit, that are most important in providing a robust basis for the recognition of fraud risk factors in the absence of accounting and disclosure requirements. The task force therefore proposes that no change be made in this respect.

13. With regard to the CAG Working Group's concern that the objectives appear unduly focused on fraud risks, the task force believes that the objectives need to be sufficiently comprehensive to address compliance frameworks that do not require disclosure of related party relationships and transactions. In those circumstances, the auditor is primarily concerned about recognizing fraud risk factors if they exist, and it is therefore appropriate that the objectives reflect this desired outcome.
14. Taking the above respondents' comments into account, and subject to the IAASB's further views, the task force proposes that the objectives of the ISA be refined as follows (see paragraph 9<sup>2</sup>):

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; and
- (b) Irrespective of whether the applicable financial reporting framework establishes related party requirements, to obtain an understanding of related party relationships and transactions sufficient to be able:
  - (I) To recognize fraud risk factors, if any, arising from related party relationships and transactions that are relevant to the identification and assessment of the risks of material misstatement due to fraud; and
  - (II) To conclude whether the financial statements, insofar as they are affected by those relationships and transactions:
    - (i) Achieve fair presentation (for fair presentation frameworks); or
    - (ii) Are not misleading (for compliance frameworks).

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

- Q1. Does the IAASB agree with the proposed refinement of the objectives as set out above?
- Q2. Does the IAASB agree that it would not be appropriate to include identification of related party relationships and transactions as one of the objectives of this ISA?

#### **B. PROPOSED RELATED PARTY DEFINITION**

15. The EM asked for respondents' views on the appropriateness of the following proposed definition of a related party:

“Related Party” – A party that:

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<sup>2</sup> Paragraph numbers refer to the revised draft of the ISA unless otherwise stated.

- (i) Controls or significantly influences, directly or indirectly through one or more intermediaries, the entity;
  - (ii) The entity controls or significantly influences, directly or indirectly through one or more intermediaries; or
  - (iii) Is under common control with the entity (such as through having common management or a common controlling shareholder).
- When the applicable financial reporting framework provides additional criteria or more specificity in defining related parties, the definition in the framework is used in addition to (i) to (iii) above.

16. Of the 41 respondents who addressed the question, the overwhelming majority<sup>3</sup> expressed support for the principles-based approach to the definition. Several of them, however, expressed reservations about certain specific aspects of the proposal as follows.

*I. Parties under Common Control*

17. Some respondents<sup>4</sup> noted that the common control part of the definition (subparagraph (iii)) was inconsistent with the proposed revised IAS 24, “Related Party Disclosures,” which the International Accounting Standards Board (IASB) issued for exposure in February 2007.<sup>5</sup> They indicated that the IASB proposed to exclude common control from its revised related party definition, except to the extent that groups or key management personnel are involved. They argued that in many instances, particularly in large complex groups or where a dominant party is involved, it would be impracticable for the auditor to identify all parties under common control, especially if the applicable financial reporting framework does not require management to identify such parties for disclosure purposes, or if management is simply unaware of such relationships. Some felt that the proposed ISA would impose a greater responsibility on the auditor than IAS 24 would impose on management.
18. Some of the respondents took the view that the common control part should be deleted, whereas others suggested narrowing the definition of common control or including further discussion of the inherent limitations in those particular circumstances. Some respondents also suggested that the reference to common control as arising from, for example, common management should be deleted as this would create a potential inconsistency with IAS 24, which states that two entities are not necessarily related simply because they have a director or other member of key management personnel in common.
19. Two IAASB CAG representatives, however, disagreed that the common control part of the definition should be changed and limited to fellow subsidiaries in the same group. They expressed the view that the existence of parties under common control increases the risks of material misstatement. They noted that fraud is often perpetuated through dominant influence being exerted via common control relationships. In addition, they noted that in

<sup>3</sup> ACAG, ACCA, AGNZ, APB, AUASB, Basel, BDO, CAASB, CEBS, CIPFA, CNCC, DTT, EC, EY, FICPA, HKICPA, ICAEW, ICAI, ICAIre, ICAP, ICAS, ICPAC, ICPAI, ICPAK, ICPAS, IDW, IEC, IRBS, KPMG, KPMGSA, Mazars, NIA, NIVRA, NZICA, PAS, and PWC.

<sup>4</sup> ACAG, BDO, CIPFA, CNCC, HKICPA, ICAS, IDW, IRBA, KPMG, KPMGSA and PwC.

<sup>5</sup> See relevant extracts in Appendix B.

many developing countries, entities might be more apt to be related through family relationships or through being under the common control of a single shareholder, than more traditional hierarchical ownership structures.

20. With respect to the broader related party definition, two respondents (AICPA and GT) suggested that the definition should focus on an *ability* to exert control or significant influence, as opposed to the existence of *active* control or significant influence. One of them (AICPA) disagreed with the rationale set forth in the EM that a criterion based on “ability” would place an undue burden on management and the auditor to identify related parties. Rather, the respondent felt that the reverse would be true. In its view, identifying related parties based on an “ability” criterion would be an objective determination based on ownership and similar factors, whereas identifying the same parties based on the existence of *active* control or significant influence would reflect a subjective determination.

#### Preliminary Task Force Views and Recommendations

21. In view of the respondents’ comments, the task force agreed that where the framework has not established any related party requirements, placing the onus on the auditor to identify the full scope of common control up front may set an unreasonable and impracticable goal as, unless management needs to identify related party relationships and transactions because of a reporting requirement, procedures such as inquiries of management would unlikely be effective. In those circumstances, the task force agreed that it would be more practicable for the auditor to focus on an upfront understanding of the entity’s organizational structure and where “active” control and significant influence exist.
22. However, the task force believes that once into the audit, it is particularly important that the auditor probe significant transactions outside the entity’s normal course of business and explicitly explore the possible effect of common control on such transactions. This approach would be the key driver to recognizing fraud risk factors when the entity has no related party reporting obligations. In those circumstances, the auditor should explore whether there may be indirect influence from related parties on such transactions through intermediaries that are not themselves related parties as defined, i.e.:

If the auditor identifies significant transactions outside the entity’s normal course of business, the auditor shall inquire of management:

- (a) To understand the nature of these transactions; and
- (b) Whether related parties could be involved. (See paragraph 17).

The task force proposes the following guidance to explain why it is important to inquire into whether related parties could be involved:

A related party could be involved in a significant transaction outside the entity’s normal course of business not only by directly influencing the transaction through being a party to the transaction, but also by indirectly influencing it through an intermediary that is not a related party as defined. For example, if the entity forms part of a group that is ultimately controlled by a person and that person also controls another group not related to the entity, that person may be able to influence the terms and conditions of a given transaction between the entity and any component of that other group. Such influence may indicate the presence of a fraud risk factor even though the transaction itself may not be deemed to be a

transaction between related parties as defined. (See paragraph A23; Appendix C to this paper illustrates this guidance).

With this approach, the task force believes that it is not eliminating consideration of common control, but addressing it from a different direction.

23. With respect to the broader definition, the task force agreed that there would be a more objective and practical basis for identifying related parties if the definition focused on an *ability* to exert control or significant influence, rather than on the existence of *active* control or significant influence. The task force noted that this would be consistent with the definitions of the terms “control” (i.e. the power to govern), and “significant influence” (i.e. the power to participate) in the proposed IAS 24 (Revised). Accordingly, the task force proposes that paragraph A5 of ED 550 be deleted and that the related party definition merely reflect the existence of control or significant influence.
24. Taking the above into account, the task force proposes the following revised definition of a related party:

“Related Party” –

- (i) A person or other entity that has control or significantly influence, directly or indirectly through one or more intermediaries, over the entity;
- (ii) Another entity over which the entity has control or significantly influence, directly or indirectly through one or more intermediaries; or
- (iii) Another entity that is under common control with the entity by virtue of being a fellow subsidiary within a group.

When the applicable financial reporting framework provides additional criteria or more specificity in defining related parties, the definition in the framework is used in addition to (i) to (iii) above. (See paragraph 10(b)).

### **Matter for IAASB Consideration**

- Q3. Does the IAASB agree with the task force’s proposed revised approach to common control in the definition of a related party, and the proposed amendment to the related party definition?

### **II. Entities Controlled or Significantly Influenced by the State**

25. Two respondents (HKICPA and PwC) pointed out that the proposed IAS 24 (Revised) would exempt reporting entities that are controlled or significantly influenced by the state from disclosure requirements in relation to transactions with entities similarly controlled or influenced by the state, provided that there is no indication that the reporting entities influence, or are influenced by, those other entities. They noted that the IASB had concluded that for those entities, the cost of complying with the disclosure requirements of IAS 24 would likely outweigh the benefit of the disclosures to the users of their financial statements. The proposed definition in ED 550, in their view, would cause difficulties for many audits in jurisdictions such as China. (A similar point was made by an IAASB CAG representative.) Accordingly, they suggested that the definition should be aligned with that

proposed in IAS 24 (Revised), with a specific exemption given to entities that are controlled or significantly influenced by the state.

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26. For the practical reasons given by the respondents, the task force agreed that entities that are controlled or significantly influenced by the state should be excluded from the scope of the related party definition, except to the extent that they form part of a group. The task force believes that restricting the scope of common control as discussed above would achieve this without the need for a specific exemption.
27. However, to further clarify the point, the task force agreed to provide the following guidance in paragraph A7 of the revised draft:

In this ISA, another entity is not considered to be a related party of the entity if it is only related because both the entity and the other entity are controlled or significantly influenced by a state (i.e. a national, regional or local government), unless there is evidence that the entity exercises influence over, or is influenced by, the other entity. Evidence of the exercise of such influence includes, for example, when the other entity:

- (a) Transacts business with the entity on terms and conditions that are not equivalent to those prevailing in arm's length transactions (otherwise than through regulation);
- (b) Shares resources with the entity; or
- (c) Engages in economically significant transactions with the entity.

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

- Q4. Does the IAASB agree that entities controlled or significantly influenced by the state should be excluded from the scope of the related party definition, except as discussed above?
- Q5. Does the IAASB agree that the proposed revised related party definition achieves this exclusion, supplemented by the guidance proposed above?

#### *III. Conflicts with the Applicable Financial Reporting Framework*

28. Where the applicable financial reporting framework establishes a definition of a related party, ED 550 allows that definition to add to, but not subtract from, the one proposed in the ISA. Some respondents (EY, ICAI and ICPAK) noted that ED 550 did not provide any guidance to deal with circumstances where parts or all of the framework definition was inconsistent with the definition in the ISA. One respondent (ICAEW) expressed concern about any attempt to compensate for perceived inadequacies in the framework through auditing standards, given the potentially wide variations that could exist in frameworks with “minimal or no” related party requirements. This respondent argued that some jurisdictions would interpret the proposed definition in the context of the proposed IAS 24 (Revised) whereas others would not.
29. Another respondent (PwC) questioned whether the proposed definition should act as a baseline in all circumstances as opposed to a default only when the framework establishes *no* related party definition and requirements. This respondent argued that the baseline



approach would compel auditors to perform a reconciliation between the definition in the framework and that in the ISA in all cases, which could prove to be onerous. Further, it questioned whether the approach taken was attempting to solve a real or theoretical issue as it was unaware of broadly used frameworks that have inadequate related party definitions and requirements. Accordingly, it suggested that the proposed ISA definition should only apply when the framework has no related party definition. Another respondent (CEB) shared a somewhat similar view, arguing that the ISA should allow the use of the definitions in IAS 24 or OECD Model Tax Conventions as an alternative to the baseline definition proposed.

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30. The task force did not agree with those views as the ISA definition is intended for the auditor's use in identifying, assessing and responding to the risks of material misstatement arising from related parties, and not to compensate for inadequacies of the framework. The task force believes that the principles-based approach to the definition in the ISA should help to minimize conflicts with the definition in the framework, subject to the overriding requirements of law or regulation. The task force, however, agreed that it would be appropriate to provide the following clarification regarding the meaning of a framework that establishes minimal related party requirements to alleviate concerns that a detailed reconciliation between the related party definition in the framework and that set out in this ISA would be expected on each audit:

An applicable financial reporting framework that establishes minimal related party requirements is one that defines the meaning of a related party but that definition has a substantially narrower scope than the definition set out in paragraph 10(b) of this ISA, so that a requirement in the framework to disclose related party relationships and transactions would apply to substantially fewer related party relationships and transactions. (See paragraph A1).

31. The task force also generally did not agree that it would be appropriate to limit the applicability of the ISA definition to circumstances where the framework has no related party definition (i.e. a default as opposed to a baseline). This is because frameworks (including compliance frameworks) may exist that define related parties in a much narrower sense than envisaged by the ISA. The task force believes that excluding such frameworks with minimal related party requirements from the scope of the related party definition in the ISA would not be in the public interest. Accordingly, the task force recommends that the approach set out in ED 550 remain unchanged.

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

- Q6. Does the IAASB agree that the related party definition should remain a baseline definition, and that it would not be appropriate for the ISA to deal with conflicts between this definition and the framework definition?
- Q7. Does the IAASB agree with the task force's proposed guidance regarding the meaning of a framework that establishes minimal related party requirements?

#### IV. Definition of “Control” and “Significant Influence”

32. A number of the respondents<sup>6</sup> noted that the proposed related party definition made reference to the undefined terms “control” and “significant influence.” They commented that for clarity and consistency of application, those terms should be defined, and suggested that the current definitions set out in IAS 24 would be appropriate for this purpose:

*Control* is the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities.

*Significant influence* is the power to participate in the financial and operating policy decisions of an entity, but is not control over those policies. Significant influence may be gained by share ownership, statute or agreement.

Some of the respondents also suggested that the related party definition should include a specific reference to *key* management personnel, consistent with the IAS 24 definition.

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33. The task force agreed with the respondents that it would be appropriate to provide guidance on the meaning of the terms “control” and “significant influence” based on the IAS 24 definitions (see paragraph A5). This will promote greater consistency of application. The task force also accepted the point regarding referring to *key* management personnel and proposes that this be reflected in the guidance on relationships that may indicate the existence of control or significant influence (see paragraph A6(c)).

#### Matter for IAASB Consideration

- Q8. Does the IAASB agree that it would be appropriate to provide guidance on the meaning of the terms “control” and “significant influence” based on the IAS 24 definitions?

#### V. Shift from an IAS 24-Based Definition to a Principles-Based Definition in the ISA

34. At the April 2007 IAASB CAG meeting, CAG representatives discussed the change in the approach to the related party definition from the extant ISA 550’s adoption of the detailed definition in IAS 24 to the provision of a more principles-based definition in ED 550. It was noted that for audits carried out in a jurisdiction where the framework does not deal with related parties, or does so inadequately, the proposed revised definition (in contrast to the previous IAS 24-based definition) did not appear to capture related party transactions that are quantitatively immaterial but qualitatively material, such as those in which the directors of the entity may be financially interested. It was argued that if a related party transaction came to light in the public arena that was quantitatively immaterial but qualitatively material, the auditor could be publicly criticized for not attending to the issue. Accordingly, it was suggested that the ISA should be more explicit in this regard.

<sup>6</sup> APB, ICAI, ICPAK, IRBA, KPMG, and KPMGSA.

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35. The task force noted that paragraph A36 of ED 550 already contained guidance indicating that 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. This is supported by the requirement in ISA 450<sup>7</sup> that in evaluating whether uncorrected misstatements are material, individually or in aggregate, the auditor should consider the size and nature of the misstatements, both in relation to particular classes of transactions, account balances and disclosures and the financial statements as a whole, and the particular *circumstances* of their occurrence.
36. ISA 450 further explains that the circumstances related to some misstatements may cause the auditor to evaluate them as material, individually or when considered together with other misstatements accumulated during the audit, even if they are lower than the materiality level for the financial statements as a whole (or for a particular class of transactions, account balance or disclosure, if any). It also provides illustrative guidance<sup>8</sup> on the types of circumstances that may affect such an evaluation, including, inter alia, “the extent to which the misstatement relates to items involving *particular parties* (e.g., whether external parties to the transaction are related to members of the entity’s management).”
37. In view of this, the task force believes that further elaboration on materiality considerations in ISA 550 would be unnecessary. The task force, however, agreed to clarify the relevant guidance in ED 550 to state the following:

A consideration of the size and nature of a related party transaction *and the circumstances of its occurrence* is important in evaluating whether a misstatement to which it gives rise is material. The significance of the transaction to the financial statement users 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. (See paragraph A43).

### Matter for IAASB Consideration

- Q9. Does the IAASB agree that this clarification, taken with the guidance already set out in ISA 450, adequately emphasizes the need for the auditor to have regard to the qualitative aspects of related party transactions?

### C. IMPLICIT ARM’S LENGTH ASSERTIONS

38. When the first exposure draft was issued at the end of December 2005, the IAASB received comments from a number of respondents who noted a recent change to the European Union’s 4th and 7th Company Law Directives that would require disclosure of material related party transactions not conducted under arm’s length or normal market conditions. The IAASB noted that a consequence of this requirement was that if related party transactions were to be *not* disclosed in the financial statements, there would be an implicit

<sup>7</sup> ISA 450, “Evaluation of Misstatements Identified During the Audit.”

<sup>8</sup> Paragraph 27 of the closed-off version of ISA 450.

assertion that they were conducted under arm's length or normal market conditions. The respondents suggested that the proposed ISA address this situation.

39. The IAASB agreed that under such a framework, there would be significant cost and practical implications in auditing related party transactions that have not been disclosed to obtain evidence that they were conducted under arm's length or normal market conditions. The IAASB did not reach a conclusion on whether the proposed ISA should address this situation but asked for respondents' views in the EM as to whether and, if so, how it should do so.
40. Of those respondents who expressed views on this question, a majority (31<sup>9</sup>) agreed that the ISA should not deal with the issue. Most argued that ISAs should be framework-neutral and should not address region- or jurisdiction-specific requirements. Some commented that introducing requirements that would not apply in all the jurisdictions that use ISAs would be contrary to the criteria the IAASB had identified under the clarity project for determining the requirements of a standard, i.e. that the requirement would be expected to be applicable in virtually all engagements to which the standard is relevant. Others noted that the auditing implications of implicit assertions are no different from those of explicit assertions, and as such there would be no justification for specific requirements in the ISA. Certain respondents argued that providing specific guidance on implicit arm's length assertions would raise questions as to whether other implicit assertions in the financial statements are also subject to specific audit procedures.
41. Several of the respondents suggested that European standard setters and regulators should work together to develop appropriate guidance for auditors to address the specific legal requirements in the Directives. Others suggested that, whilst the ISA should not establish specific requirements to deal with implicit arm's length assertions, it could provide some guidance to indicate that the auditing implications of arm's length assertions are the same, whether they are explicit or implicit. A few respondents noted that the ISAs are sufficiently robust to guide the auditor to undertake the procedures and actions that are appropriate in the circumstances of the framework, without the need for specific provisions to accommodate or address specific regulations.
42. A minority of respondents<sup>10</sup> were in favor of specific provisions in the ISA to deal with implicit arm's length assertions. Some noted that whilst ISAs should not deal with jurisdiction-specific issues, where issues arise in a number of jurisdictions they cease to be jurisdiction-specific. Consequently, they felt that the IAASB should address the issue and suggested certain approaches, such as substantiating completeness on the basis of risk, and focusing on performing work on the specific controls the entity might have put in place. One respondent expressed the view that the auditor has a responsibility to audit arm's length assertions that management has made for related party transactions, regardless of whether those assertions are implicit or explicit, and suggested that the relevant requirements in the ISA specifically refer to the assertions as being either explicit or

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<sup>9</sup> ACAG, AGNZ, AICPA, APB, AUASB, BDO, CAASB, CEB, CIPFA, CNCC, EC, EY, FEE, FICPA, GT, HKICPA, ICAI, ICAP, ICAS, ICPAC, ICPAI, ICPAK, IRBA, JICPA, KPMG, KPMGSA, NIVRA, NZICA, PAS, PwC, and SNAO.

<sup>10</sup> CEBS, DTT, ICAEW, ICAIre, IDW, IEC, IRE and WAO

implicit. Others argued that it would be in the public interest for auditors to be made aware of situations where implicit assertions might need to be audited, and suggested that guidance should be provided to make auditors aware of the fact that implicit assertions would need to be audited in accordance with the ISA.

43. At the September 2007 IAASB CAG meeting, some CAG representatives expressed concern about transfer pricing and argued that auditors need to consider whether transactions have been conducted at arm's length because this could affect tax obligations. Other CAG representatives cautioned, however, that such issues raise questions of political and legal interpretation that cannot be addressed through the financial statement audit.

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44. Given that no new arguments have been raised in favor of dealing with implicit arm's length assertions in the ISA, the task force believes that it remains appropriate to avoid making any specific reference to such assertions in the ISA. This approach would maintain the framework neutrality of the ISA, which is critically important to ensure its global acceptance. The task force agrees with many of the respondents who have suggested that this issue should be more appropriately dealt with at the national or jurisdictional level, where specific and detailed guidance could be developed to address the issue. Accordingly, as ED 550 did not make any reference to implicit or explicit arm's length assertions, the task force recommends that no change be made.

**Matter for IAASB Consideration**

Q10. Does the IAASB agree that no change should be made to the ISA to address implicit and explicit arm's length assertions?

**D. INHERENT LIMITATIONS**

45. Paragraph 7 of ED 550 highlighted the inherent limitations on the auditor's ability to detect material misstatements associated with related parties, and noted that those limitations are greater because of certain characteristics pertaining to the nature of related party relationships and transactions.
46. A number of respondents<sup>11</sup> argued that the proposed ISA should place *further* emphasis on the difficulties in obtaining persuasive audit evidence regarding the completeness of related party relationships and transactions. In particular, one respondent (IDW) commented that for related parties, the general inherent limitations of an audit result in particularly severe specific inherent limitations due to the difficulty in obtaining persuasive audit evidence about related party relationships and transactions. The respondent expressed the view that the procedures set out in the proposed ISA, such as inquiry of management and inspection of documents, would not help the auditor obtain as high a degree of comfort as could be obtained for other matters. Accordingly, it suggested that the ISA should make clear that *even when following all the requirements of this and the other ISAs* (including determining the necessity for additional procedures in the circumstances), there would still be a

<sup>11</sup> CNCC, FEE, ICAEW and IDW

considerable risk that related parties, or related party relationships or transactions, might not be identified. Another respondent (ICAEW) suggested that the ISA should emphasize that whilst the auditor would obtain reasonable assurance on related party transactions, the level of assurance obtained would likely be lower than that obtained for other assertions.

47. One respondent (CPAB) took an opposite view, arguing that the proposed ISA still placed too much emphasis on the inherent limitations on the auditor's ability to detect material misstatements arising from related party relationships and transactions. This respondent noted that inherent limitations exist in every auditing technique and that the emphasis on the inherent limitations in this case might provide an excuse for auditors to be less than thorough in their search for evidence. It added that there would also be a risk that auditors would not be as inquisitive as they should be about matters that management might regard as sensitive. Another respondent (EC) argued for any discussion of inherent limitations to be centralized in ISA 200, which addresses the fundamental concepts of an audit.
48. At the September 2007 IAASB CAG meeting, although a few CAG representatives argued for additional emphasis on the inherent limitations, most were supportive of the task force's position.

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49. The task force noted that the issue of inherent limitations was discussed at length by the IAASB in finalizing ED 550. As the EM noted, the IAASB concluded that it was important to highlight the inherent limitations on the auditor's ability to identify related party relationships and transactions because of the special nature of related parties, but agreed to do so in such a way as to achieve a balanced message. The views expressed by the above respondents continue to represent the two opposing sides on this issue, and as such the task force believes it remains particularly important to maintain an appropriate balance in the ISA.
50. Finally, the task force noted that the issue of whether inherent limitations should be dealt with centrally in ISA 200 was given due consideration by the IAASB when it finalized ED 550. As such, it does not represent a new issue. The task force therefore proposes that the approach taken to describing inherent limitations in ED 550 remain unchanged.

**Matter for IAASB Consideration**

Q11. Does the IAASB agree that the matter of inherent limitations remains appropriately addressed in the proposed ISA?

E. DEFINITION OF DOMINANT INFLUENCE

51. The re-exposure draft proposed the following definition of the term "dominant influence:"

"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;

Several respondents submitted the following significant comments on this proposal.

52. *Linkage with the definition of a related party.* A number of the respondents<sup>12</sup> noted that ED 550 defined the term “dominant influence” but did not specify its inter-relationship with the proposed definition of a related party. In their view, this gives rise to uncertainty as to whether dominant parties are a subset of related parties, and whether the requirements set out in ED 550 would also apply to dominant parties. They also noted the following:

- ED 550 defined a related party as a party that “controls or significantly influences” rather than a party that has the *ability* to control or significantly influence. By contrast, the definition of “dominant influence” did not distinguish between an individual imposing his will from one who has the ability to impose his will.
- It was unclear whether the definition was intended to include representatives of corporate entities such as pension funds or private equity groups, or whether it was limited to individuals acting in a private capacity.
- Care should be taken that the proposed ISA does not indirectly establish a new accounting concept, given that IAS 24 does not itself define a dominant party.
- The last sentence of the proposed definition cast doubt as to whether management or those charged with governance do in fact fall within the definition of a related party.

Some of the respondents (ACCA, APB and DTT) suggested that a definition of “dominant influence” might not be needed, especially given the small number of references to it in the proposed ISA.

53. *Control or significant influence.* Two respondents (Basel and CEBS) suggested that the definition should hinge on the concept of control or significant influence (as those terms are more commonly used and understood) as opposed to the imposition of an individual’s will on others. They believed that the latter criterion would set a very high threshold and could be interpreted inconsistently.

54. *Guidance relating to the ability to exercise dominant influence as a fraud risk factor (paragraph A20 of ED 550).* Some respondents commented on this guidance as follows:

- Two respondents (DTT and GT) suggested that the guidance would be more appropriate for ISA 240 in the context of the discussion of other potential fraud risk factors.
- Another respondent (APB) disagreed that the ability of entities to exercise dominant influence should always be considered a fraud risk factor because the dominant influence that a parent entity exerts over its components would not necessarily imply a fraud risk factor.

55. *Auditor’s responsibilities with regard to dominant parties.* One respondent (EC) noted that other than a response to identified dominant parties, the proposed ISA was silent as to the auditor’s responsibilities towards them. It therefore suggested that the ISA should more clearly specify what would be required of the auditor in the context of dominant parties, for

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<sup>12</sup> ACCA, AICPA, APB, Basel, CEBS, DTT, EC, GT and IDW.  
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example, by requiring the auditor to include dominant parties when inquiring of management as to the existence of related parties.

56. *Definition of “dominant party.”* Some of the respondents (AICPA, Basel and JICPA) noted that ED 550 used the undefined term “dominant party” rather than the defined term “dominant influence.” Accordingly, they suggested that the proposed ISA should define the former as opposed to the latter.

At the September 2007 IAASB CAG meeting, some CAG representatives supported having a definition of “dominant influence” in the Definitions section so that the issue is given greater visibility at the beginning of the ISA, as dominant influence has proven to underlie a number of frauds.

*Preliminary Task Force Views and Recommendations*

57. In light of the respondents’ comments, the task force reconsidered whether the definition of a dominant party can be sufficiently clearly differentiated from the generic related party definition. The task force concluded that such differentiation would be difficult given that the notion of imposing one’s will is essentially indistinguishable from the concept of exerting control, i.e. a dominant party is in fact a related party. The task force therefore agreed that the definition of dominant influence should be deleted but that the concept should be dealt with in the application material in the context of fraud risk factors.
58. In that regard, the task force proposes to clarify the guidance on a dominant party being a fraud risk factor by noting that ISA 240 already establishes that domination of management by a single person or small group of persons without compensating controls is a fraud risk factor. The task force is of the view that the implication of dominant influence in the context of related parties could simply be made clear if the ISA were to state that a related party *may* be in a position to exert such dominant influence (see paragraph A26 of the revised draft). This approach would thus make clear that the ability to exert dominant influence depends upon the party exerting the influence being a related party in the first instance.
59. The task force did not agree with the suggestion that the guidance on dominant influence should be moved to ISA 240 given that the linkage between ISA 550 and ISA 240 has now been well established. The task force, however, believes that it would be appropriate to include a cross-reference from ISA 240 to ISA 550 in relation to this guidance as a conforming amendment.

<b>Matters for IAASB Consideration</b>
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| <p>Q12. Does the IAASB think that the definition of dominant influence should be deleted?</p> <p>Q13. Does the IAASB agree with the revised guidance on dominant influence in paragraph A26?</p> |
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- F. FRAMEWORKS THAT DEAL WITH RELATED PARTIES ADEQUATELY AND THOSE THAT DO NOT
60. Paragraphs 14 and 15 of ED 550 specified the following requirements when the applicable financial reporting framework establishes related party requirements and when it does so only minimally or not at all:



14. If the applicable financial reporting framework establishes related party requirements, the auditor shall:

- (a) Obtain from management the names of the related parties that management has identified in accordance with the framework; and
- (b) Inquire of management regarding:
  - (i) The nature of the relationships between the entity and these related parties; and
  - (ii) Whether the entity entered into any transactions with these related parties during the period, and if so, the general nature of the transactions.

15. If the applicable financial reporting framework establishes minimal or no related party requirements, the auditor shall inquire of management regarding:

- (a) The identity of the parties:
  - (i) That control or significantly influence the entity;
  - (ii) That the entity controls or significantly influences; or
  - (iii) That are under common control with the entity; and
- (b) The nature of any business undertaken between the entity and these parties.

61. Several respondents<sup>13</sup> commented that the distinction between those two requirements was very subtle and that it would present practical difficulties for auditors in interpreting the requirements. They also commented that:

- These requirements are not truly mutually exclusive because under the condition precedent in paragraph 15 of ED 550, minimal related party requirements are still related party requirements and so these cases would fall under the scope of paragraph 14 of ED 550.
- The implications of the different procedures required under the two sets of circumstances (such as a requirement to *obtain* the names of related parties from management vs a requirement to *inquire* of management as to the identify of specified parties) were unclear.
- In practice, a requirement to inquire into the nature of any “business” between the parties (ED 550, paragraph 15(b)) would likely result in inquiries into the nature of the relationships and transactions (ED 550, paragraph 14(b)). Consequently, these two specific aspects of the requirements could be merged into one.
- Whilst paragraph 23 of ED 550 specified requirements that would apply if the auditor determined that the information obtained under paragraph 14 was incomplete, there was no corresponding requirement for action if the information obtained under paragraph 15 was found to be incomplete.

62. One respondent (CNCC) suggested clarifying the meaning of a framework that has “minimal related party requirements,” such as by clearly stating that the related party

<sup>13</sup> ACCA, APB, CEBS, CNCC, FEE, IDW, IRBA, KPMG and KPMGSA.

definition in such a framework is narrower than that set out in ED 550. Two other respondents (FEE and IDW) suggested that differentiating between the requirements as proposed in the exposure draft is unhelpful and unnecessary given that the intention is to require the auditor to perform the same work based on the auditor's definition of a related party or an expanded version thereof based on the additional requirements of the framework. Accordingly, they suggested setting one principles-based requirement covering the related parties that would fall under the ISA definition and any additional parties that the framework might specify. They also suggested removing the framework distinction throughout the proposed ISA except in the explanatory material in the introduction.

63. In addition, two respondents (AICPA and DTT) suggested that to avoid confusion, the sub-bullets in paragraph 15(a) of ED 550 should be identical to the wording in the sub-bullets of the related party definition.

*Preliminary Task Force Views and Recommendations*

64. The task force noted that the original intention behind paragraph 15 of ED 550 was to enable the auditor to identify the parties that are “pulling the strings” (based on who is *actively* controlling or significantly influencing the entity), rather than to completely identify all the parties that are related to the entity. This is because when the framework has not established any related party requirements, it would be unlikely that management would have established the information systems necessary to identify all related party relationships and transactions. Given the revised approach to the related party definition, however, the task force believes that it is no longer appropriate to make the distinction between parties that are actively controlling or significantly influencing the entity, and parties that have the ability to control or significant influence the entity, as reflected in the different procedures in paragraphs 14 and 15 of ED 550.
65. The task force therefore agreed with the respondents' suggestion above that there should be one principles-based requirement addressing related parties as defined in the ISA and any additional parties that the applicable financial reporting framework might specify (see paragraph 13). The task force believes that this would result in a clearer requirement regarding inquiry of management that auditors would be able to apply consistently irrespective of the framework.
66. In the specific case where the framework has not established any related party requirements, the task force believes that inquiry of management regarding the entity's related party relationships and transactions would likely not yield useful information because management might not have established the necessary information systems to identify such relationships and transactions. Rather, the task force believes that in those circumstances, the auditor's inquiries regarding the identity of the entity's related parties are likely to form part of the auditor's risk assessment procedures and related activities that the auditor is required to perform under ISA 315 to obtain information regarding:
- 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.

Accordingly, the task force agreed to provide guidance to that effect in paragraph A10.

**Matters for IAASB Consideration**

Q14. Does the IAASB agree with the task force's proposed approach to the requirement regarding inquiry of management with respect to the entity's related party relationships and transactions, and the proposed guidance in paragraph A10?

**G. CONTROLS TO AUTHORIZE AND APPROVE SIGNIFICANT TRANSACTIONS AND ARRANGEMENTS OUTSIDE THE NORMAL COURSE OF BUSINESS**

67. Paragraph 16 of ED 550 proposed to require the auditor to, inter alia, "obtain an understanding of the controls that management has established to authorize and approve significant transactions and arrangements outside the normal course of business."
68. One respondent (APB) expressed the view that this proposed requirement would likely cause significant confusion in practice and suggested that it be deleted. The respondent argued that in many circumstances, requiring the auditor to obtain an understanding of the controls that management has established to authorize and approve significant transactions and arrangements "outside the normal course of business" would be impracticable because entities do not typically establish controls that they would regard as addressing a limited number of matters "outside the normal course of business." The respondent pointed out that, instead, entities would be more likely to establish different authorization procedures for transactions and contracts with particular parameters or characteristics (such as total value, volume discounts or credit terms), and that management would regard these as being within the normal course of business. The respondent also added that this proposed requirement would inevitably result in management asking the auditor to define the meaning of the phrase "outside the normal course of business," which the respondent felt would likely be impossible to do.

*Preliminary Task Force Views and Recommendations*

69. The task force acknowledged the respondent's concerns and noted that the proposed ISA already provides guidance on transactions outside the entity's normal course of business (see paragraph A21). The task force agreed that the approach to understanding controls should vary depending on whether the entity has established controls over related party relationships and transactions. Thus, where the entity has established such controls, the auditor should focus primarily on those controls to authorize and approve significant transactions and arrangements with related parties, as these would likely address those significant transactions and arrangements with related parties that are outside the normal course of business (see paragraph 14).
70. Where no such controls exist, however, the majority of the task force believes that the auditor may still be able to obtain useful information regarding fraud risk factors and risks of material misstatement by inquiring into controls to authorize and approve significant transactions and arrangements outside the entity's normal course of business. Accordingly,

the task force proposes amending the requirement to make that distinction clear (see paragraph 15).

**Matter for IAASB Consideration**

Q15. Does the IAASB agree with the task force's proposed approach regarding inquiry of management to obtain an understanding of the entity's controls?

H. INSPECTION OF BANK AND LEGAL CONFIRMATIONS, AND MINUTES OF MEETINGS

71. Paragraph 19 of ED 550 proposed that, in addition to being alert to arrangements or other information that may indicate the existence of related party relationships or transactions, the auditor shall inspect the following documents for such information:

- (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.

72. Several respondents<sup>14</sup> commented that this proposed requirement is inconsistent with the risk-based approach underlying the ISAs. They expressed concern about making the proposed ISA overly specific and prescriptive, and suggested that there is little justification for *requiring* those specific documents (as opposed to the other types of documents set out in paragraph A19 of ED 550) to be inspected. Some also commented that:

- There would be a risk that some auditors would interpret such a list as being the maximum work effort required in the circumstances; and
- ISA 550 is an inappropriate ISA for a general requirement to inspect minutes of meetings of shareholders and of those charged with governance.

73. The respondents provided a number of suggestions as follows:

- The auditor should determine the documents to inspect based on an assessment of the risk that management has failed to identify all related parties.
- The three types of documents included in the requirements section (bank confirmations, legal confirmations and minutes of meetings) should be moved to the application material and included in the illustrative list of documents that the auditor could inspect.
- A conforming amendment should be made to ISA 315 to require the auditor to inspect the minutes of meetings of shareholders and those charged with governance as part of the auditor's risk assessment procedures.

74. One respondent (CPAB) took the view that the list of documents proposed in the requirements section should be supplemented by other types of documents such as regulatory filings and tax returns on the ground that these represent important sources of related party information. Similarly, other respondents (HKICPA, NZICA) suggested that the requirement should include specific significant contracts and agreements outside the normal course of business, and shareholder registers.

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<sup>14</sup> CAASB, DTT, EY, HKICPA, ICAIre, ICPAK, KPMG, KPMGSA, NZICA and PAS.

75. With regard to the related guidance in paragraph A19 of ED 550, one respondent (KMPG) commented that the intent of the guidance was unclear as it did not provide criteria that the auditor would apply in determining whether or not to inspect the documents listed.
76. At the September 2007 IAASB CAG meeting, some CAG representatives expressed the view that the re-exposure draft appeared less robust than either the extant ISA or the first exposure draft in the work effort expected in this part of the ISA. One representative noted, for example, that a requirement to “be alert” sounded rather passive. This representative expressed a preference for more specific procedures to be required.

*Preliminary Task Force Views and Recommendations*

77. The task force noted that most of these concerns were voiced during the first consultation. As the EM noted:

The IAASB acknowledged the force of these concerns. However, the IAASB 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 related party relationships and transactions would be appropriate because this would be too open-ended. It also noted that there were other respondents who supported the list of records that should be reviewed, and who had proposed that some of the examples included in the application material should be added to the list of records required to be reviewed. The IAASB therefore decided to retain a revised list of records and documents that the auditor is to review, combined with a general requirement for the auditor to be alert for significant transactions outside the normal course of business, as well as arrangements or other information that may indicate the existence of unidentified or undisclosed related party relationships or transactions. The IAASB believes that this will reinforce the need for the auditor to be looking for unidentified or undisclosed related party relationships and transactions when performing all other audit procedures.

The approach upon which the IAASB agreed is therefore intended to strike an appropriate balance between those who favor a high-level requirement based on judgment and those who favor a requirement focusing on inspection of specific types of documents. The IAASB settled on the three types of documents listed in the requirement on the grounds that these should be inspected in all cases *if they are available*, and the fact that they often contain information on related party relationships and transactions.

78. The task force also noted that the requirement to review some of these documents, such as minutes of meetings of shareholders and those charged with governance, is already an existing requirement in the extant ISA 550. Deleting such a requirement would therefore represent a weakening of the ISA. Accordingly, the task force recommends that the requirement to review the specified documents set out in the exposure draft be retained. The task force, however, agreed to clarify that the documents listed represent the minimum level of work effort required (see paragraph 18).
79. With regard to the related guidance in paragraph A19 of ED 550, the task force believes that it would be impracticable to specify criteria because the determination as to whether to inspect specific types of documents would depend on the engagement circumstances (e.g.

some entities may not have internal audit working papers) and the other risk assessment procedures the auditor has planned. Accordingly, the task force agreed to clarify the guidance to indicate that in the course of performing other risk assessment procedures, the auditor may also inspect some or all of the records or documents listed (see paragraph A24).

**Matters for IAASB Consideration**

Q16. Does the IAASB agree that the requirement for the auditor to inspect the list of documents in paragraph 17 should remain unchanged?

Q17. Does the IAASB agree with the clarification made in paragraph A24?

**I. MATTERS TO BE TREATED AS SIGNIFICANT RISKS**

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

80. ED 550 proposed to require the auditor to treat as a significant risk identified significant related party transactions outside the normal course of business. One respondent (CNCC) argued that this requirement should be further clarified because there could be two ways to approach the issue, i.e.
- The ISA could state that significant related party transactions outside the normal course of business are *presumed* to be significant risks (in which case there would be no need for the auditor to exercise professional judgment to decide whether the risk is significant but the presumption would be rebuttable); or
  - The ISA could introduce the *possibility* for the auditor to apply professional judgment and require a consideration of whether those transactions give rise to significant risks (in which case the auditor would be required to document the rationale supporting his or her conclusion).

**Preliminary Task Force Views and Recommendations**

81. The task force believes that in this particular case, the IAASB's original view remains valid. Under ISA 315 (Redrafted),<sup>15</sup> factors that may give rise to significant risks include, inter alia, whether the risk involves significant transactions with related parties, and whether the risk involves significant transactions outside the entity's normal course of business. In the task force's view, the combination of these two factors in significant related party transactions outside the entity's normal course of business would cause these transactions to reach such a threshold of risk as to require special audit consideration in *all* circumstances. In other words, there would not be any circumstance in which a significant related party transaction outside the entity's normal course of business would not deserve the auditor's special attention. Accordingly, the task force agreed that the auditor should treat such transactions as giving rise to significant risks by default (see paragraph 19).
82. Subject to the IAASB's views regarding the above, the task force believes that a conforming amendment would be necessary to Appendix 1 of ISA 240 (Redrafted) to

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<sup>15</sup> ISA 315 (Redrafted), "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and its Environment."

delete “significant related party transactions not in the ordinary course of business” from the list of examples of fraud risk factors.

**Matter for IAASB Consideration**

Q18. Does the IAASB agree that significant related party transactions outside the entity’s normal course of business should give rise to significant risks by default?

*Arm’s Length Assertions*

83. Paragraph 21 of ED 550 proposed to require the auditor to treat as a significant risk *any* arm’s length assertion that management has made in the financial statements with regard to a related party transaction.
84. Several respondents<sup>16</sup> disagreed with this proposal. They argued that many transactions with related parties (for example, subsidiaries) are uncomplicated transactions conducted on the same terms and conditions as transactions with external parties in the normal course of business, and therefore such related party transactions are unlikely to represent higher inherent risks. Consequently, they expressed the view that an arm’s length assertion regarding such transactions would not represent a higher inherent risk in all circumstances. They also noted the following:
- The proposal seemed inconsistent with the explanatory material in paragraph 2 of ED 550, which states that many related party transactions in the normal course of business carry no higher risk of material misstatement than similar transactions with unrelated parties.
  - It was unclear why such assertions should *always* represent significant risks.
  - In practical terms, the proposed requirement could capture a high volume of routine transactions with related parties that would not constitute a significant risk.
  - The determination of significant risks in accordance with ISA 315 is a matter for the auditor’s professional judgment because it should take into account consideration of many factors.
  - The proposed approach could discourage entities to volunteer such disclosures when organizations such as the OECD are encouraging companies to make disclosures that transactions with subsidiaries are conducted at arm’s length to promote fair-trading globally.

Most of the respondents therefore suggested that this requirement should be deleted. One respondent (IDW) suggested that the requirement should be revised to establish a *presumption* of significant risk.

**Preliminary Task Force Views and Recommendations**

85. The task force acknowledged the force of these concerns and agreed that this requirement could cause practical difficulties. The task force believes that in these circumstances, it

<sup>16</sup> CNCC, CEB, DNR, FEE, HKICPA, ICAEW, ICAS, IDW, IRBA, JICPA, KPMG and PwC.

would be more appropriate to adopt an approach based on evaluating the relevant factors (as ISA 315 envisages) in determining whether a significant risk is present. The task force did not agree that a presumption of significant risk in this case would be appropriate as rebutting the presumption (with a requirement to document the basis for the rebuttal) would likely prove to be difficult and unduly burdensome for the auditor. Accordingly, the task force proposes that this requirement be deleted.

**Matter for IAASB Consideration**

Q19. Does the IAASB agree that arm's length assertions for related party transactions should not be significant risks by default?

**J. PREVIOUSLY UNIDENTIFIED OR UNDISCLOSED RELATED PARTY RELATIONSHIPS AND TRANSACTIONS**

86. For engagements where the applicable financial reporting framework establishes related party requirements, paragraph 23 of ED 550 specified the following list of required procedures in the event that the auditor identifies related parties or significant related party transactions that management has not previously identified or disclosed to the auditor:

- (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
- (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 are aware of the information already communicated by the auditor), and (ii) evaluate the implications on the audit.

87. A number of respondents<sup>17</sup> argued that these required procedures should apply to *all* engagements, regardless of whether the framework establishes related party requirements. One of the respondents (KPMGSA), however, took the view that the only procedure that might not apply where the framework has established no related party requirements would be the requirement to inquire of management as to why the entity's controls did not capture those related party relationships and transactions.

*Preliminary Task Force Views and Recommendations*

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<sup>17</sup> CIPFA, FEE, IDW, KPMG and KPMGSA.



88. The task force noted that the main reason why these procedures were limited to only those circumstances where the framework has established related party requirements is that if the framework does not contain any such requirements, management is unlikely to have established the information systems and controls necessary to identify, monitor, record, summarize and report related party relationships and transactions. In addition, management's lack of familiarity with the auditor's related party definitions may very well cause it to miss disclosing certain related parties or related party transactions to the auditor upon inquiry. Under those circumstances, procedures such as requesting management to identify all transactions with the newly identified related parties or inquiring as to why the entity's controls over related party relationships and transactions did not catch the exceptions, would be impracticable.
89. The task force, however, reconsidered the other procedures in the proposed requirement and concluded that they should apply to all engagements because they should not in fact be conditional upon the framework having established related party requirements. Further, with regard to the requirement to communicate with those charged with governance under procedure (e), the task force agreed that this would be covered by the general requirement in paragraph 28 for the auditor to communicate significant related party matters with those charged with governance. The task force therefore proposes that paragraph 23 of ED 550 be restructured accordingly (see paragraphs 23 and A47).

**Matter for IAASB Consideration**

Q20. Does the IAASB agree with the task force's proposed restructuring of paragraph 23 as discussed above?

**K. WRITTEN REPRESENTATIONS**

90. In circumstances where the applicable financial reporting framework establishes related party requirements, paragraph 27 of ED 550 proposed to require the auditor to obtain, in addition to any specific written representations believed necessary, general 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.
91. Several respondents<sup>18</sup> disagreed with the proposal to limit the requirement to only those circumstances where the framework establishes related party requirements. They suggested that such representations should *also* be obtained when the framework establishes minimal or no related party requirements, and that in those cases, the representations should be based on the related party definition set out in the ISA. They argued that this would be

<sup>18</sup> CAASB, DTT, EY, FEE, GT, ICAIre, IDW, IRBA and KPMGSA.  
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consistent with achieving the objectives set out in paragraph 10(b) of ED 550. In particular, in the absence of specific requirements for related parties in the framework, the auditor would still have a responsibility to determine that the financial statements are not misleading. They also commented that this would:

- Enable the auditor to corroborate the inquiries performed under paragraph 15 of ED 550.
- Be essential for the auditor's evaluation required by paragraph 26 of ED 550.
- Be particularly important given the inherent limitations facing the auditor when auditing related party transactions.

The respondents therefore suggested that the IAASB consider establishing a principles-based requirement that would apply in all circumstances.

92. One respondent (EC) noted that the proposed requirement dealt with representations that are in fact of a general nature. Accordingly, the respondent suggested that the requirement be either moved to ISA 580 or clarified to focus more on specific representations.

*Preliminary Task Force Views and Recommendations*

93. The task force noted that the issue of the scope of written representations was discussed at length by the IAASB in finalizing ED 550. The IAASB concluded that the practical difficulties in obtaining written representations when the framework does not define the concept of a related party would make a requirement to obtain such representations in this case unworkable. Although the respondents' arguments have merit and are forceful, the task force believes that these arguments would not be capable of overcoming the practical barriers that would exist in the aforementioned circumstances. In particular, there would be a strong likelihood that in those circumstances, management would *refuse* to provide such representations as they may not understand the meaning of a related party as defined for audit purposes, leading to the significant possibility that the auditor would have to qualify the audit opinion on scope limitation grounds.
94. The task force also believes that a representation in this case would be covered by the proposed general requirement under the project to revise ISA 580<sup>19</sup> for the auditor to obtain a written representation from management that it has provided the auditor with all the information the auditor required in connection with the audit of the entity. Notwithstanding this requirement in the proposed revised ISA 580, the task force is also of the view that the absence of a specific requirement for written representations in this case should not preclude the auditor from obtaining any particular written representations the auditor believes are appropriate. Accordingly, the task force proposes that no change be made to the approach in the ED.
95. With regard to the comment that the representations are general in nature, the task force agreed to revise the requirement to eliminate the distinction between general and specific representations, in line with the decision taken by the IAASB in the Written Representations project (see paragraph 27).

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<sup>19</sup> ISA 580, "Written Representations."

**Matter for IAASB Consideration**

Q21. Does the IAASB agree that the scope of the requirement to obtain written representations should continue to be limited to circumstances where the framework defines a related party?

**L. GROUP AUDITS**

96. One respondent (CNCC) argued that the ISA should differentiate the extent of work effort between cases where the auditor is engaged to audit consolidation packages in group audits and cases where the auditor is engaged to audit standalone financial statements. The respondent noted that intra-group transactions would be eliminated on consolidation and, accordingly, there would be no need for such transactions to be subject to the requirements of the ISA. The respondent expressed the view that in such circumstances, the ISA should only apply to related party transactions that are outside the group.

*Preliminary Task Force Views and Recommendations*

97. The task force believes that although intra-group transactions are expected to be eliminated on consolidation, they could still give rise to risks of material misstatement due to error or fraud at the component level. This view received support during discussions at the IAASB CAG where some of the CAG representatives argued that the auditor's responsibility should go beyond accepting elimination of intra-group transactions and balances on consolidation. In particular, risks of material misstatement may arise from transfer pricing arrangements in a group context, and intra-group transactions may be used as a vehicle for fraud. In addition, the task force believes that the ISA does not impose a significant amount of additional work effort in the audit of a component subject to consolidation than it does in the audit of a standalone entity. For these reasons, the task force agreed that the scope of the ISA should include intra-group transactions.

**Matters for IAASB Consideration**

Q22. Does the IAASB agree that the scope of the ISA should not exclude intra-group transactions?

## Appendix A

### List of Respondents

IFAC member bodies: 24

Regulators: 5

Firms: 8

Governmental: 5

Others (standard setters, industry, etc.): 9

#	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	Auditor-General of New Zealand	AGNZ	Governmental
5	Australian Auditing and Assurance Standards Board	AUASB	Other
6	Australasian Council of Auditors-General	ACAG	Governmental
7	Basel Committee on Banking Supervision	Basel	Regulator
8	BDO Global Coordination B.V	BDO	Firm
9	Canadian Auditing and Assurance Standards Board	CAASB	Other
10	Canadian Public Accountability Board	CPAB	Regulator
11	Chartered Institute of Public Finance and Accountancy	CIPFA	Member Body
12	Compagnie Nationale des Commissaires aux Comptes & Conseil Supérieur de l'Ordre des Experts-Comptables	CNCC	Member Body
13	Confederation of European Business (BusinessEurope)	CEB	Other
14	Committee of European Banking Supervisors	CEBS	Regulator
15	Deloitte Touche Tohmatsu	DTT	Firm
16	Den Norske Revisorforening	DNR	Member Body
17	Ernst & Young	EY	Firm
18	European Commission	EC	Regulator
19	Foreningen Auktoriserade Revisorer (FAR-SRS)	FAR	Member Body
20	Federation des Experts Comptables Europeens	FEE	Other
21	Florida Institute of Certified Public Accountants	FICPA	Other
22	Grant Thornton International	GT	Firm

#	Respondent	Ref	Group
23	Hong Kong Institute of Certified Public Accountants	HKICPA	Member Body
24	IEC	IEC	Other
25	Independent Regulatory Board for Auditors, South Africa	IRBA	Other
26	Institut der Wirtschaftsprüfer	IDW	Member Body
27	Institut des Reviseurs d'Entreprises/ Instituut der Bedrijfsrevisoren	IRE	Member Body
28	Institute of Certified Public Accountants of Cyprus	ICPAC	Member Body
29	Institute of Certified Public Accountants in Ireland	ICPAI	Member Body
30	Institute of Certified Public Accountants of Kenya	ICPAK	Member Body
31	Institute of Certified Public Accountants of Singapore	ICPAS	Member Body
32	Institute of Chartered Accountants in England and Wales	ICAEW	Member Body
33	Institute of Chartered Accountants of India	ICAI	Member Body
34	Institute of Chartered Accountants in Ireland	ICAIre	Member Body
35	Institute of Chartered Accountants of Pakistan	ICAP	Member Body
36	Institute of Chartered Accountants of Scotland	ICAS	Member Body
37	International Organisation of Securities Commissions	IOSCO	Regulator
38	The Japanese Institute of Certified Public Accountants	JICPA	Member Body
39	Korean Institute of Certified Public Accountants	KICPA	Member Body
40	KPMG	KPMG	Firm
41	KPMG South Africa	KPMGSA	Firm
42	Koninklijk Nederlands Instituut van Registeraccountants (Royal NIVRA)	NIVRA	Member Body
43	Dr. Joseph Maresca CPA, CISA	JM	Other
44	Mazars	Mazars	Firm
45	National Institute of Accountants, Australia	NIA	Member Body
46	New Zealand Institute of Chartered Accountants	NZICA	Member Body
47	PricewaterhouseCoopers	PwC	Firm
48	Provincial Auditor Saskatchewan	PAS	Governmental
48	Riksrevisionen (Swedish National Audit Office)	SNAO	Governmental
50	Welsh Audit Office, UK	WAO	Governmental

## APPENDIX B

### Revised Definition of “Related Party” in the Proposed IAS 24 (Revised)

The comment period on the IASB’s exposure draft of IAS 24 (Revised) closed on May 25, 2007. The IASB is currently analyzing comments received on its proposals to revise the definition of “related party” and related terms, and is expected to issue the final standard in the fourth quarter of 2007. The IASB’s proposed revised definition of a related party is as follows:

*A related party* is a person or entity that is related to an entity that is preparing its financial statements (in this Standard referred to as the ‘reporting entity’).

- (a) A person or a close member of the family of that person is related to a reporting entity if either person:
  - (i) is a member of the key management personnel of the reporting entity or a parent of the reporting entity;
  - (ii) has control over the reporting entity; or
  - (iii) has joint control or significant influence over the reporting entity.
- (b) An entity is related to a reporting entity if:
  - (i) the entity and the reporting entity are members of the same group (which means that each parent, subsidiary and fellow subsidiary is related to the others);
  - (ii) the reporting entity is an associate or joint venture of the entity (or of a member of a group of which the entity is a member);
  - (iii) the entity is an associate or joint venture of the reporting entity (or of a member of a group of which the reporting entity is a member);
  - (iv) the entity is a post-employment benefit plan for the benefit of employees of either the reporting entity or an entity related to the reporting entity;
  - (v) the entity is controlled by a person identified in (a);
  - (vi) the entity is one in which a person identified in (a)(i) or (a)(ii) holds significant voting power or has joint control or significant influence; or
  - (vii) a member of the key management personnel of the entity, or a parent of the entity, has control, joint control or significant influence over, or significant voting power in, the reporting entity.

The proposed IAS 24 (Revised) also defines a state as follows:

A state is a national, regional or local government.

In addition, it proposes to exclude state-controlled entities from disclosure requirements as follows:

**17A. A reporting entity is exempt from the disclosure requirements of paragraph 17 in relation to an entity if:**

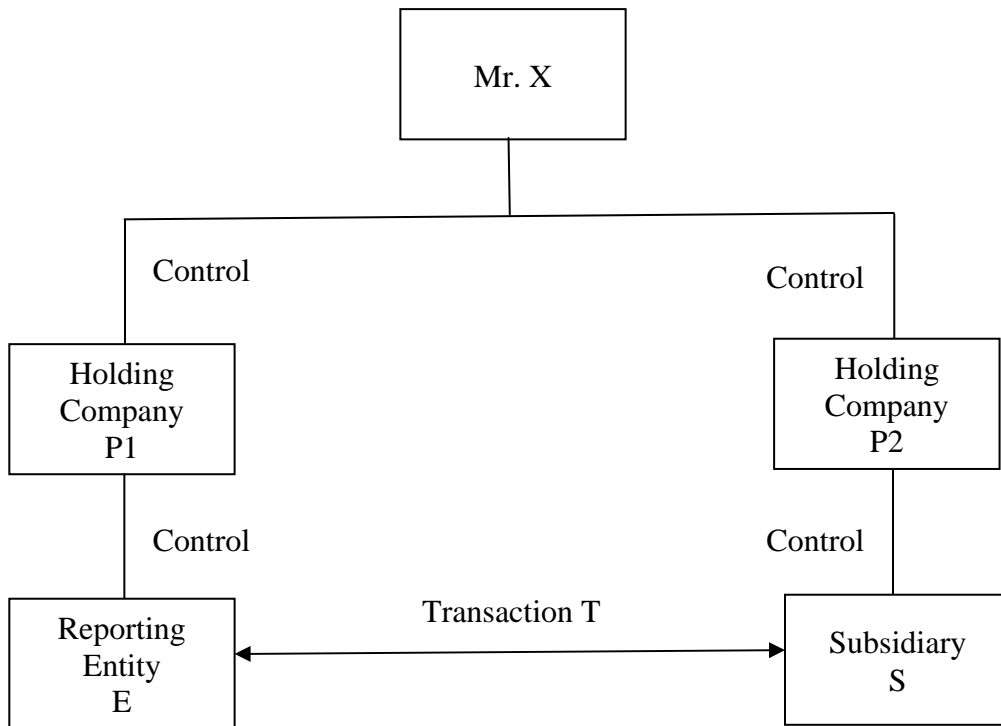
- (a) the entity is a related party only because the reporting entity is controlled or significantly influenced by a state and the other entity is controlled or significantly influenced by that state; and
- (b) there are no indicators that the reporting entity influenced, or was influenced by, that entity.

17B. Indicators that the influence referred to in paragraph 17A(b) exists are when the related parties:

- (a) transact business at non-market rates (otherwise than by way of regulation);
- (b) share resources; or
- (c) engage in economically significant transactions with each other.

## APPENDIX C

### Illustration of the Exercise of Common Control Indirectly Through an Intermediary (Paragraph A23 of revised draft)



In this illustration, the reporting entity E is ultimately controlled by a person, Mr. X, through the holding company P1. The holding company P2 and its subsidiary S are not related parties of E as defined in this ISA, even though they are both also controlled by Mr. X. By virtue of this common control, Mr. X is capable of indirectly influencing, through the intermediary P2, the terms and conditions of the transaction T between E and S.