



**International Federation of Accountants**

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## **Agenda Item**

# **2**

**Committee:** IAASB

**Meeting Location:** New York

**Meeting Date:** March 10-14, 2008

### **Related Parties**

#### **Objective of Agenda Item**

1. To review and approve as a final standard the proposed ISA 550 (Revised and Redrafted), *Related Parties*.

#### **Task Force Composition**

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

#### **Activities since Last IAASB discussions**

3. The task force met in January 2008 to discuss the significant comments received from the IAASB on the first-read draft, post-exposure, at the December 2007 meeting, and a comment letter from one respondent (IOSCO) that was received after the task force had finalized its earlier deliberations. The task force held a conference call in February 2008 to finalize the wording of the draft now being presented.

#### **Significant Issues**

4. The following summarizes the significant issues raised at the December 2007 IAASB meeting, including the IAASB's consideration of comments submitted by IOSCO on the second exposure draft (ED), and the task force's recommendations.
  - A. OBJECTIVES
5. At the December 2007 meeting, it was suggested that the order of the objectives would be more logical if the "obtaining an understanding" part were to be placed first, followed by the part dealing with obtaining sufficient appropriate audit evidence, and finally the part dealing

with concluding on whether the financial statements achieve fair presentation or are not misleading.

6. The task force agreed that it would be appropriate to re-order the objectives so that the “obtaining an understanding” part would precede the part dealing with obtaining sufficient appropriate audit evidence. The task force, however, noted that the part dealing with concluding on whether the financial statements achieve fair presentation or are not misleading needs to remain bracketed by the phrase “irrespective of whether the applicable financial reporting framework establishes related party requirements” because that part is applicable even if the framework does not deal with related parties. To make this emphasis even clearer, the task force proposes that the part dealing with obtaining sufficient appropriate audit evidence be introduced by the phrase “In addition, where the applicable financial reporting framework establishes related party requirements” (see below).
7. Finally, as agreed by the IAASB in response to a comment from IOSCO that the objectives seemed to be missing sufficient coverage of the need to *identify* related party relationships and transactions, the task force has amended the objectives so that they now also focus on obtaining sufficient appropriate audit evidence about whether related party relationships and transactions have been appropriately identified:

9. The objectives of the auditor are:

(a) 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:

- a. Achieve fair presentation (for fair presentation frameworks); or
- b. Are not misleading (for compliance frameworks); and

(b) In addition, where the applicable financial reporting framework establishes related party requirements, to obtain sufficient appropriate audit evidence about whether related party relationships and transactions have been appropriately identified, accounted for and disclosed in accordance with the framework.

**Matter for IAASB Consideration**

Q1. Does the IAASB agree with the proposed revised wording of the objectives?

**B. DEFINITION OF RELATED PARTY**

8. In response to comments on exposure, the task force had proposed to amend the principles-based definition of a related party to limit the common control part of the definition to cases

where the entity and the other party are fellow subsidiaries within a group. At the December 2007 meeting, it was noted that this would inappropriately narrow the scope of the definition. It was pointed out that management might very well be aware of other parties that are under common control (otherwise than in a group situation), and by effectively not being required to make the initial inquiries of management regarding such parties, the auditor would be exposed to the risk that these parties would remain undetected, even though their existence was known and management had no intention of concealing them. Further, it was argued that fellow subsidiary cases are likely to be the least problematical in practice because transactions among them would be eliminated on consolidation.

9. The task force acknowledged these concerns and agreed to remove the fellow subsidiary limitation. Nevertheless, the task force believes that it is particularly important to ensure that the common control part of the definition does not set unrealistic expectations regarding what the auditor can achieve in identifying related parties and related party transactions *in those circumstances where the framework does not establish related party requirements*. This is because in such a case, the entity would likely not have the necessary information systems in place to deal with identification, except to the extent that components within a group need to be identified if a consolidation requirement exists under the framework. In particular, it is unlikely that management will have reason to identify parties that are related to the entity through common control other than to know the parents and fellow subsidiaries in a group situation. Further, the primary purpose of the auditor's inquiries of management in such a case is not to obtain audit evidence regarding the completeness of management's list of related parties, as would be necessary if the framework established related party disclosure requirements, but to recognize the existence of fraud risk factors arising from the influence of a common controlling party. Such risks are more likely to exist when there is activity that could influence the entity's financial results.
10. Therefore, the task force believes that for the auditor's inquiries of management to be effective, it is both practicable and appropriate that they be focused on circumstances where the entity has *engaged in significant transactions or shared resources to a significant degree* with entities under common control. Although management may not be aware of all common control relationships, they are likely to know the relationships that have economic significance to the entity's operations.
11. Accordingly, the task force proposes to:
  - Make clear in the definition that, for the purposes of the ISA, another entity is a related party of the entity if both are under common control through having:
    - a. Common controlling ownership;
    - b. Owners who are close family members; or
    - c. Common key management; and
  - Emphasize in the definition that the concept of common control is only relevant for the auditor's purposes if the entities have engaged in significant transactions or shared resources to a significant degree with one another. (See paragraph 10(b)(iii)).

12. The task force believes that it is important that the articulation of the common control part of the definition explicitly include owners who are close family members (i.e. part b. above) because such persons (e.g. husband and wife, or two siblings) may be able to exert common control over both the entity and the other entity by acting together, in substance, as a single controlling party.
13. The task force believes that this approach establishes an appropriate and practical basis upon which the auditor will be able to probe management regarding parties under common control where there are no related party requirements under the framework.
14. The task force also agreed that under this approach, state-controlled entities would be scoped-in through the “common controlling ownership” part of the definition (the common owner being the state), provided there is evidence that the entities have engaged in significant transactions or shared resources to a significant degree with one another.

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

- Q2. Does the IAASB agree with the task force’s proposed revised approach to the common control part of the related party definition?

#### **C. DEFINITION OF DOMINANT INFLUENCE**

15. The second ED proposed to establish the following definition of the term “dominant influence” in response to comments from respondents to the first ED that the meaning of the term was unclear:

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.

16. A number of respondents to the second ED, however, commented that it was unclear from this definition whether a party with dominant influence is in fact a related party. The task force believes that this is indeed the case because the concept of being able to impose one’s will necessarily implies the ability to exercise control. To avoid the confusion caused by this definition, the task force therefore proposed at the December 2007 meeting that the description of dominant influence be moved to the application material where it can be explained.
17. In its comment letter, IOSCO suggested that a definition for “dominant party” be established as follows:

“Dominant party – An individual or individuals who have the ability to impose their will on the entity through exercising dominant influence.”

Further, at the September 2007 IAASB CAG meeting, some CAG Representatives did not support moving the description of dominant influence to the application material. They felt that having a definition would give important visibility to the issue, as dominant influence has proven to underlie a number of significant frauds.

18. The task force notes that under IOSCO’s proposed definition, confusion would remain as to whether a party with dominant influence is a related party. Further, the concept of dominant influence itself is undefined under this proposal. The task force notes that a number of respondents to the second ED had suggested that a definition might not be needed, given the single reference to a party with dominant influence in the Requirements section of that ED.<sup>1</sup> After further consideration, and for the reasons explained above, the task force concluded that a formal definition would be unnecessary. Nevertheless, to give the issue greater visibility and to make clear that a related party may be able to exert dominant influence, the task force agreed to bring forward the guidance describing the nature of dominant influence from the section of the application material addressing the identification and assessment of risks to the section addressing the definition of a related party:

A7. A person who is a related party may be in a position to exert dominant influence over the entity or its management. This type of influence may be evidenced in such ways as the following:

- The related party has vetoed significant business decisions taken by management or those charged with governance.
- Significant transactions are referred to the related party for final approval.
- There is little or no debate among management and those charged with governance regarding business proposals initiated by the related party.
- Transactions involving the related party (or a close family member of the related party) are rarely independently reviewed and approved.

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

19. In addition, to ensure that visibility is given to the importance of considering possible dominant influence when identifying fraud risk factors, the task has retained the reference to this in the requirement addressing the identification of fraud risk factors:

20. If the auditor identifies fraud risk factors (including circumstances relating to the existence of a party with dominant influence) when performing the risk assessment procedures and related activities in connection with related parties, the auditor shall consider such information when identifying and assessing the risks of material misstatement due to fraud in accordance with ISA 240 (Redrafted).

### **Matters for IAASB Consideration**

- Q3. Does the IAASB agree it is unnecessary to define the terms “dominant influence” and “dominant party” in the ISA?
- Q4. Does the IAASB agree that the task force’s proposed placement of the guidance describing the

<sup>1</sup> This reference has been retained in paragraph 20 of the proposed final wording.

nature of dominant influence provides appropriate visibility to the issue?
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D. INSPECTION OF DOCUMENTS

20. At the December 2007 meeting, the IAASB noted IOSCO's comment that the second ED seemed to have established a more modest standard for the identification and auditing of related party transactions compared with the first one. IOSCO noted, in particular, that the first ED had required the auditor to:

Review appropriate records or documents for transactions that are both significant and non-routine, and for other information that may indicate the existence of previously unidentified or undisclosed related party relationships or transactions. Appropriate records or documents that the auditor reviews shall include:

- (i) Bank and legal confirmations obtained by the auditor; and  
(ii) Minutes of meetings of shareholders and those charged with governance, and other relevant statutory records.

IOSCO commented that while inquiries of management are required under the first and second EDs, it appeared that the records that were provided as two presumptively mandatory examples in the first ED had now become the only documents the auditor is specifically required to review. IOSCO was concerned that this contributed to a shift from an overall approach of requiring the auditor to "look for transactions outside the normal course of business" to an approach whereby "if the auditor finds transactions outside the normal course of business, then the auditor should do the following."

21. The IAASB acknowledged these concerns. Nevertheless, the IAASB agreed that for cost-benefit reasons, it is necessary that any search for previously unidentified or undisclosed related party relationships or transactions should be driven by risk considerations. As IOSCO itself has acknowledged (and as other respondents to the first ED had noted), the auditor's search for related parties and related party transactions cannot be open-ended and limitless. Indeed, an open-ended search would be particularly onerous where the risk is assessed as low.
22. In light of this, and as guided by the IAASB, the task force has revised the requirement to inspect documents to include a more active obligation to inspect such other documents *as the auditor considers are likely, in the entity's circumstances*, to contain information that may indicate the existence of previously unidentified or undisclosed related party relationships or transactions:

15. The auditor shall inspect for information that may indicate the existence of related party relationships or transactions that management has not previously identified or disclosed to the auditor:

- (a) Bank and legal confirmations obtained as part of the auditor's procedures;  
(b) Minutes of meetings of shareholders and of those charged with governance; and  
(c) Such other documents as the auditor considers are likely to contain such information in the circumstances of the entity. (Ref: Para. A24)

23. Paragraph A24 of the application material then sets out examples of the types of documents that may provide such information:

A24. Documents that may provide information about related party relationships and transactions include:

- Third party confirmations obtained by the auditor (in addition to bank and legal confirmations).
- Entity income tax returns.
- Information supplied by the entity 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.
- Contracts and agreements with key management or those charged with governance.
- Significant contracts and agreements not in the entity's ordinary course of business.
- Specific invoices and correspondence from the entity's professional advisors.
- Life insurance policies acquired by the entity.
- Significant contracts re-negotiated by the entity during the period.
- Internal audit reports.
- Documents associated with the entity's filings with a securities regulator (for example, prospectuses).

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

- Q5. Does the IAASB agree with the proposed revised wording of the requirement regarding inspection of documents?

#### **E. SPECIAL PURPOSE ENTITIES**

24. At the December 2007 meeting, the IAASB took note of a concern from IOSCO that the second ED did not seem to give sufficient attention to the potential complexities and risks associated with special purpose entities (SPEs), and that these should receive some mention in the requirements. The IAASB acknowledged that SPEs are a current issue of the day. Nevertheless, it also noted that there might well be other structures that could be devised in future that could also give rise to related party issues. The IAASB took the view that SPEs are in fact already covered by the broad principles set out in the ISA and other ISAs, including the requirements to:

- Understand the entity's related party relationships and transactions, including how the entity is structured and the nature of the investments it has made;

- Identify and assess the risks associated with those relationships and transactions; and
- Respond appropriately to the assessed risks.

Accordingly, the IAASB concluded that it would be inappropriate to give SPEs special mention in the requirements in the ISA. The IAASB, however, instructed the task force to consider placing additional emphasis on SPEs in the application material.

25. In light of this, the task force proposes to further explain the nature of an SPE in the section of the application material addressing the definition of a related party, and to clarify that the entity may, in substance, control an SPE even if it owns little or none of the SPE's equity:

#### *Special Purpose Entities as Related Parties*

A8. A special purpose entity (sometimes referred to as a special purpose vehicle) is an entity that is generally established for a narrow and well-defined purpose, such as to effect a lease or a securitization of financial assets, or to carry out research and development activities. It may take the form of a corporation, trust, partnership or unincorporated entity. The entity on behalf of which the special purpose entity has been created may often transfer assets to the latter (for example, as part of a derecognition transaction involving financial assets), obtain the right to use the latter's assets, or perform services for the latter, whilst other parties may provide the funding to the latter.

A9. In some circumstances, the entity may in substance control a special purpose entity, even if the entity owns little or none of the special purpose entity's equity. Financial reporting frameworks often specify detailed conditions that are deemed to amount to control, or circumstances under which the special purpose entity should be considered for consolidation. The interpretation of the requirements of such frameworks often demands a detailed knowledge of the relevant agreements involving the special purpose entity.

26. In addition to the existing references to SPEs in paragraphs A11 and A21, the task force also proposes to include a further mention of SPEs in the third bullet of paragraph A10, i.e.

- 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, *use of special purpose entities for off-balance sheet transactions*, or an inadequate information system).

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

- Q6. Does the IAASB agree with the proposed additional guidance on SPEs?

#### **F. IDENTIFICATION AND ASSESSMENT OF RISKS**

27. IOSCO commented that the first ED contained guidance on the circumstances that are indicators of potential risk, i.e.:

- (a) Management has not identified or disclosed to the auditor one or more of the entity's related parties;



- (b) Management has not identified or disclosed to the auditor relationships and transactions with identified related parties; or
- (c) Management has not appropriately accounted for or disclosed identified related party relationships or transactions in accordance with the applicable financial reporting framework.

IOSCO noted that such guidance provides a very helpful listing of indicators of heightened risk involving related party transactions, and suggested that the ISA would be weaker without this guidance.

- 28. The task force agreed that the guidance provides a helpful reminder of the nature of the risks associated with related party relationships and transactions that the auditor should be looking for where the framework establishes related party requirements. Accordingly, the task force proposes to reinstate this guidance in paragraph A31.

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

Q7. Does the IAASB agree to include the guidance set out in paragraph A31 in the final ISA?

#### **G. IDENTIFICATION OF PREVIOUSLY UNIDENTIFIED OR UNDISCLOSED RELATED PARTIES OR SIGNIFICANT RELATED PARTY TRANSACTIONS**

- 29. In its comment letter on the second ED, IOSCO noted that the list of required actions to be taken when the auditor identifies related parties or significant related party transactions that management has not previously identified or disclosed to the auditor did not include what the auditor should do to investigate whether *other* unidentified or undisclosed related parties or significant related party transactions might exist.
- 30. The task force agreed that it would be appropriate to specify the action the auditor should take in such a case. This action will involve a reconsideration of the risk that other unidentified or undisclosed related parties or significant related party transactions may exist, which may trigger the need to revise the nature and extent of the audit procedures already performed. Accordingly, the task force proposes to revise paragraph 23 to that effect:

23. If the auditor identifies related parties or significant related party transactions that management has not previously identified or disclosed to the auditor, the auditor shall:

...

- (d) Reconsider the risk that related parties or significant related party transactions may exist that management has not previously identified or disclosed to the auditor, and perform additional audit procedures as necessary.

...

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

Q8. Does the IAASB agree with the proposed addition to paragraph 23?

H. CONSIDERATION OF THE NEED TO RE-EXPOSE

31. As further illustrated and explained in the comparison document (Agenda Item 2-C), the main changes from the first ED to the second ED, and from the second ED to the proposed final wording, in response to significant comments received from respondents, include:
- Setting out clearly in the Objectives the specific responsibilities that the auditor is required to fulfill in connection with related parties.
  - The provision of a baseline principles-based definition of a related party.
  - The establishment of a robust risk assessment process to identify and assess the risks associated with related parties, including:
    - A requirement to understand the controls over the authorization and approval of significant transactions and arrangements with related parties, and those that are outside the normal course of business;
    - A tighter integration with ISA 240 (Redrafted)<sup>2</sup> in relation to the identification and assessment of risks of material misstatement due to fraud; and
    - A requirement to maintain a heightened state of alert to the existence of unidentified or undisclosed related party relationships or transactions throughout the audit.
  - The establishment of robust responses to the assessed risks, including:
    - A requirement to determine whether previously unidentified or undisclosed related party relationships or transactions exist if the auditor identifies arrangements or information that suggests this possibility;
    - Additional required responses when the auditor identifies previously unidentified or undisclosed related parties or significant related party transactions; and
    - Guidance on procedures to respond to a significant risk of material misstatement due to fraud associated with a party with dominant influence.
  - The provision of expanded guidance on parties with dominant influence, and SPEs.
32. The task force believes that the changes reflected in the proposed final wording do not establish new principles or substantively new requirements compared with the second ED. Accordingly, the task force believes that the changes do not warrant re-exposure.

**Matter for IAASB Consideration**

Q9. Does the IAASB agree that re-exposure is not necessary?

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<sup>2</sup> ISA 240 (Redrafted), “The Auditor’s Responsibilities Relating to Fraud in an Audit of Financial Statements.”

**Material Presented**

Agenda Item 2-A (Pages 13 – 38)	Revised Draft of the Proposed ISA 550 (Revised and Redrafted) (Mark-up from December 2007 meeting)
Agenda Item 2-B (Pages 39 – 64)	Revised Draft of the Proposed ISA 550 (Revised and Redrafted) (Clean)
Agenda Item 2-C (Pages 65 – 86)	Comparison of First and Second EDs and Proposed Final Wording

**Draft of the ISA to be Discussed at the Meeting**

The task force proposes that the **mark-up** version of the revised draft (**Agenda Item 2-A**) be discussed at the meeting.

**Action Requested**

The IAASB is asked to consider the above issues and approve the revised draft of the proposed ISA 550 (Revised and Redrafted) as a final standard.

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