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# Basis for Conclusions: ISA 550 (Revised and Redrafted), Related Parties

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*Prepared by the Staff of the International Auditing and  
Assurance Standards Board*



**International Federation  
of Accountants**

**BASIS FOR CONCLUSIONS:  
ISA 550 (REVISED AND REDRAFTED), RELATED PARTIES**

This Basis for Conclusions has been prepared by staff of the International Auditing and Assurance Standards Board (IAASB). It relates to, but does not form part of, ISA 550 (Revised and Redrafted), “Related Parties,” which was unanimously approved by the IAASB in March 2008.<sup>1</sup>

## **Background**

1. The audit of related party transactions is an essential part of an audit of financial statements. Although such transactions are a common feature of business, they may give rise to specific risks of material misstatement of the financial statements (including the risk of material misstatement due to fraud) because of the nature of related party relationships.
2. The IAASB commenced this project in response to a number of developments that pointed to a need to revise the ISA. In particular:
  - The major corporate scandals of the earlier part of this decade have highlighted that fraudulent financial reporting often arises through the involvement of related parties. Because related parties are not independent of each other, the IAASB believes there is a need to emphasize that even when the applicable financial reporting framework establishes no related party requirements (or does so inadequately), it is necessary for the auditor to be aware of related parties and their effect on the financial statements.
  - As a result of the issue of the audit risk standards, there was a need to revise extant ISA 550, which is mainly procedural, to focus more on the identification and assessment of risks of material misstatement associated with related party relationships and transactions, and on the responses to such risks.
3. In December 2005, the IAASB published a first exposure draft of proposed ISA 550 (Revised and Redrafted), “Related Parties,” prepared in accordance with the IAASB’s Clarity conventions.<sup>2</sup> Significant and substantive changes were made to the proposed ISA as a result of the comments received from respondents to that exposure draft. Accordingly, the IAASB determined that re-exposure of the revised draft was necessary. The IAASB issued the re-exposure draft (“Re-ED”) in February 2007. A staff-prepared Basis for Conclusions was issued with the Re-ED to explain the significant changes made to the first exposure draft in response to comments received from respondents.
4. The comment period for the Re-ED closed on June 30, 2007. The IAASB received fifty comment letters from various respondents, IFAC member bodies, national standard setters,

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<sup>1</sup> See minutes of the March 10-14, 2008 IAASB meeting at <http://www.ifac.org/IAASB/Meeting-BGPapers.php?MID=0142>.

<sup>2</sup> The IAASB’s Clarity conventions, and the authority and obligation attaching to them, are established in the amended Preface to the International Standards on Quality Control, Auditing, Review, Other Assurance and Related Services (Preface). The amended Preface can be accessed at [http://www.ifac.org/download/IAASB\\_Preface.pdf](http://www.ifac.org/download/IAASB_Preface.pdf). Elements of the authority and obligation attaching to the Clarity conventions have been exposed as part of ISA 200 (Revised and Redrafted), “Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing.”

firms, regulators, government organizations and others. This Basis for Conclusions explains the more significant issues raised by respondents to the Re-ED, and how the IAASB has addressed them.

5. The IAASB has discussed this project with its Consultative Advisory Group (CAG) on eight occasions.

## **Objectives of the ISA**

6. In revising the proposed ISA in response to comments received on the first exposure draft, the IAASB concluded that the objectives of the ISA should reflect the three distinct responsibilities of the auditor with respect to related parties, that is.:
  - (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:
      - a. Achieve fair presentation (for fair presentation frameworks); or
      - b. 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.
7. There was clear overall support from the respondents for this approach to the objectives. A number of respondents, however, offered the following suggestions:
  - A few of them were of the view that the objectives should not include the phrase *“irrespective of whether the applicable financial reporting framework establishes related party requirements”* on the basis that a principles-based objective should not refer to a specific financial reporting framework. They were also of the view that the phrase was redundant. The CAG working group assigned to this project, however, advised 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.
  - Some suggested that the objectives would be clearer and flow better if the “obtaining an understanding” part were to be placed first on the basis that obtaining sufficient appropriate audit evidence depends on the auditor first obtaining an understanding and assessing risk. Some CAG Representatives, however, were of the view that an objective to conclude (i.e. part (b)(i) of the proposed objectives) should not precede an objective to obtain sufficient appropriate audit evidence (part (a) of the proposed objectives).

- A few 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.
- Finally, a few suggested that the objectives should give greater recognition to the identification of related party relationships and transactions.

## **IAASB Decisions**

8. Although the phrase “irrespective of whether the applicable financial reporting framework establishes related party requirements” does not, in substance, change the meaning of the objectives, the IAASB determined that, on balance, it should be retained. This is because the phrase appropriately emphasizes, in the particular context of this ISA, that the objectives in parts (b)(i) and (b)(ii) above apply regardless of the requirements, if any, that the framework may specify for related parties. The IAASB does not believe that including this phrase undermines the framework neutrality of the ISA but doing so helps to ensure that the intent of the objectives is appropriately emphasized.
9. In relation to the flow of the objectives, the IAASB accepted that it would be more logical to re-order the different parts so that the “obtaining an understanding” part precedes the part dealing with obtaining sufficient appropriate audit evidence. The IAASB, 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 further emphasize this particular point and to appropriately contrast the different situations, the IAASB determined that the part dealing with obtaining sufficient appropriate audit evidence should be introduced by the phrase “In addition, where the applicable financial reporting framework establishes related party requirements,” because that part of the objectives applies only when the framework deals with related parties.
10. With regard to the identification of fraud risk factors, the IAASB accepted the point that fraud risk factors may not be identified in all circumstances. Accordingly, it determined that the qualifying words “if any” should be incorporated into this objective, and also agreed to amend the wording of that objective to be more clearly consistent with ISA 240 (Redrafted).<sup>3</sup>
11. In relation to comments that the proposed objectives provided insufficient coverage of the need to identify related party relationships and transactions, the IAASB noted that identification is implicit in the objective to obtain sufficient appropriate audit evidence about whether related party relationships and transactions have been appropriately accounted for and disclosed in accordance with the framework. Nevertheless, the IAASB accepted that this could be made more explicit in that context. Where the framework does not establish related party requirements, however, the IAASB is of the view that setting an

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<sup>3</sup> ISA 240 (Redrafted), “The Auditor’s Responsibilities Relating to Fraud in an Audit of Financial Statements.”

identification objective would be impracticable as management may well not have put in place the systems needed to identify related party relationships and transactions, and would see no need to do so. Further, it is the recognition of fraud risk factors that is the key objective in those circumstances, rather than obtaining audit evidence about the completeness of the entity's related parties. Consequently, the IAASB agreed that the reference to identification in the objectives should be limited to circumstances where the framework specifies related party requirements.

12. The final objectives, reflecting the above decisions, are set out in paragraph 9 of the ISA.

### **Related Party Definition**

13. The Re-ED asked for respondents' views on the appropriateness of the following proposed definition of a related party:

Related Party – A party that:

- (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.

14. The overwhelming majority of respondents expressed support for the principles-based approach to the definition. A number of respondents, however, offered suggestions about specific aspects of the definition.

### **Parties under Common Control**

15. Several respondents suggested that in many instances, particularly in large complex groups or where a party with dominant influence 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. Some 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. A few 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 International Accounting Standard (IAS) 24,<sup>4</sup> which states that two entities are not necessarily related simply because they have a director or other member of key management personnel in common.

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<sup>4</sup> IAS 24, "Related Party Disclosures."

16. Some CAG Representatives, however, disagreed that the common control part of the definition should be changed. They expressed the view that the existence of parties under common control increases the risks of material misstatement. They noted that fraud is often perpetrated through dominant influence being exerted via common control relationships. In addition, they noted that in 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 in more traditional hierarchical ownership structures.
17. With respect to the broader related party definition, a few respondents 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 the respondents disagreed with the rationale set forth in the explanatory memorandum to the Re-ED 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 involve a subjective determination.

#### *IAASB Decisions*

18. The IAASB determined that the related party definition would be clearer if it first specified that a related party is as defined in the applicable financial reporting framework. The principles-based definition in the ISA would apply only where the framework establishes minimal or no related party requirements.<sup>5</sup>
19. The IAASB did not agree that the common control part of the principles-based definition should be deleted because of the perceived difficulties in identifying all parties under common control when the framework does not deal with related parties. The IAASB noted that management might very well be aware of parties under common control in those circumstances, and by effectively not requiring the auditor to make the initial inquiries of management regarding the existence of such parties, there would be an unacceptable risk of these parties going undetected, even though their existence was known and management had no intention of concealing them.
20. The IAASB, however, acknowledged the practical difficulties that exist in trying to identify parties under common control, and the need to set requirements that will be workable from a cost-benefit perspective in those framework circumstances. Accordingly, the IAASB made two specific provisions in addressing the issue of common control.
21. Firstly, the IAASB determined that the scope of common control that the auditor should consider should be limited to circumstances involving:
  - (a) Common controlling ownership;

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<sup>5</sup> Paragraph A1 of the ISA provides guidance on what a framework with minimal related party requirements means; it is presumed that a framework with no related party requirements will not define the concept of a related party.

- (b) Owners who are close family members; or
- (c) Common key management. (See paragraph 10(b)(ii)c. of the ISA).

The IAASB believes that these will cover the vast majority of cases of common control. By circumscribing the scope of common control in this way, the ISA establishes practical boundaries for the auditor's inquiries and other audit procedures where the framework deals with related parties minimally or not at all. The IAASB agreed 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., spouses or siblings) have the ability to exert common control over both the reporting entity and the other entity by acting together in concert as a single controlling party.

- 22. Secondly, as management is more likely to be aware of common control relationships if they have economic significance to the entity, the IAASB is of the view that the auditor's inquiries are likely to be more effective if they are focused on whether parties with which the entity engages in significant transactions, or shares resources to a significant degree, are related parties. The IAASB therefore agreed that guidance to that effect should be provided to explain the approach the auditor may take when making the relevant inquiries of management (see paragraph A12 of the ISA).
- 23. The IAASB believes that the above provisions establish an appropriate and practical basis upon which the auditor will be able to probe management regarding parties under common control when there are no related party requirements under the framework.
- 24. With regard to the broader related party definition, the IAASB 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 IAASB 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 IAS 24. Accordingly, the IAASB deleted paragraph A5 of the Re-ED and concluded that the related party definition should merely reflect the existence of control or significant influence.

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

- 25. A few respondents noted that a current revision of IAS 24 would exempt a reporting entity that is controlled or significantly influenced by the state from disclosure requirements in relation to transactions with another entity similarly controlled or influenced by the state, provided that there is no indication that the reporting entity influences, or is influenced by, the other entity. They further noted that the International Accounting Standards Board had concluded that for such a reporting entity, the cost of complying with the disclosure requirements of IAS 24 would likely outweigh the benefit of the disclosures to the users of the financial statements. They suggested that the proposed related party definition in the Re-ED would cause difficulties for many audits in jurisdictions where state-controlled enterprises are common. (A similar point was made at the CAG.) Accordingly, the respondents 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.

#### *IAASB Decision*

26. The IAASB acknowledged these concerns and agreed that it would not be appropriate to indiscriminately treat all entities that are under common control by a state as related parties. The IAASB noted that in some jurisdictions, entities may be under the common control of the state merely by virtue of the dominant role that the state plays in the local economy, without the entities in fact having any significant business relationships with one another. In those circumstances, it would be neither logical nor meaningful to capture such entities within the related party definition for the purposes of the audit.
27. The IAASB, however, determined that entities that are under common control by a state and that engage in significant transactions or share resources to a significant extent with one another *should* be deemed to be related in the context of the audit because fraud risk factors are more likely to arise from the existence of such business relationships. The IAASB believes that it is appropriate that the requirements of the ISA should apply to such entities. Accordingly, the common control part of the related party definition in the ISA excludes entities that are under common control by a state except when they engage in significant transactions or share resources to a significant extent with one another.

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

28. Where the applicable financial reporting framework establishes a definition of a related party, the Re-ED proposed that this definition could add to, but not subtract from, the one proposed in the ISA. A few respondents noted that the Re-ED did not provide any guidance to deal with circumstances where parts or all of the framework definition was inconsistent with the definition proposed in the ISA. One respondent 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 proposed IAS 24 (Revised) whereas others would not.
29. Another respondent 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, the respondent suggested that the proposed ISA definition should only apply when the framework does not deal with related parties. Another respondent shared a somewhat similar view, arguing that the ISA should allow the use of the definitions in IAS 24 or the OECD Model Tax Conventions as an alternative to the baseline definition proposed.



### *IAASB Decisions*

30. The IAASB 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 IAASB 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 IAASB, however, agreed that it would be appropriate to provide the following clarification in paragraph A1 of the ISA 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)(ii) 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.

31. In addition, the IAASB determined that it would clearer if the reference to the related party definition in the framework were to be mentioned first in the ISA definition (see paragraph 10(b)(i) of the ISA) as opposed to being dealt with as a last consideration as proposed in the Re-ED. This is because in the overwhelming majority of cases, the framework definition will likely meet or exceed the definition set out in paragraph 10(b)(ii) of the ISA.
32. The IAASB 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 IAASB 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 IAASB determined that the definition in the ISA should remain a baseline definition, while allowing for some flexibility by focusing on those circumstances when the definition in the framework is substantially narrower in scope than the definition in the ISA.

### **Definition of “Control” and “Significant Influence”**

33. Some respondents 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, i.e.:

*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.

34. 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.

#### *IAASB Decisions*

35. The IAASB generally did not agree that it would be appropriate to define the terms “control” and “significant influence” in the ISA as these terms are accounting terms that financial reporting frameworks usually define. However, the IAASB determined that some guidance on how frameworks generally define these two terms would be appropriate. Accordingly, guidance to that effect has been included in paragraph A4 of the ISA.
36. The IAASB accepted the point regarding referring to *key* management personnel. Accordingly, appropriate references to such individuals have been included in the related party definition (paragraph 10(b)(ii)c.iii.) and in the guidance on relationships that may indicate the presence of control or significant influence (paragraph A5(c)).

#### **Definition of Dominant Influence**

37. The Re-ED proposed the following definition of the term “dominant influence” in response to comments from respondents to the first exposure draft that the term was not defined:

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.

38. Several respondents commented that it was unclear from this definition whether a party with dominant influence is in fact a related party. They also noted that the Re-ED used the undefined term “dominant party” rather than the defined term “dominant influence,” and that it was unclear whether the proposed 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. A few of them suggested that the definition should focus on the concept of control or significant influence (as those terms are more commonly used and understood) rather than on the imposition of an individual’s will on others, on the ground that the latter criterion would set a very high threshold and could be interpreted inconsistently. One of the respondents suggested that the ISA should specify more clearly the auditor’s responsibilities regarding dominant parties, for example, by requiring the auditor to include dominant parties when inquiring of management as to the existence of related parties.
39. A few of the respondents suggested that a definition of “dominant influence” might not be needed, given the single reference to a party with dominant influence in the Requirements

section of the Re-ED.<sup>6</sup> With regard to the guidance relating to the ability to exercise dominant influence as a fraud risk factor (paragraph A20 of the Re-ED), a few other respondents suggested that the guidance would be more appropriate for ISA 240 (Redrafted) in the context of the discussion of other potential fraud risk factors.

40. 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 significant frauds.

### **IAASB Decisions**

41. The IAASB reconsidered whether the definition of a party with dominant influence can be sufficiently clearly differentiated from the generic related party definition. The IAASB 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. Given the single reference to dominant influence in the ISA, the IAASB determined that a formal definition would be unnecessary. Nevertheless, to respond to the concerns raised, the IAASB determined that the application material of the ISA should more fully explain the interrelationship between the concepts of a related party and dominant influence, and how consideration of fraud risk factors becomes especially relevant in the presence of dominant influence. The IAASB believes that this approach better clarifies the relevant considerations regarding the matter of dominant influence and will help eliminate the confusion caused by the proposed definition.
42. Accordingly, paragraph A6 of the ISA explains that *related parties* may be in a position to exert *dominant influence* over the entity or its management by virtue of their ability to exert control or significant influence. It further explains that consideration of such behavior is relevant when identifying and assessing the risks of material misstatement due to fraud. The ISA then provides further guidance on indicators of dominant influence being exerted by a related party, in the context of identifying and assessing the risks of material misstatement associated with related party relationships and transactions (paragraph A29). It also explains that, in the presence of other risk factors, the existence of a related party with dominant influence may indicate significant risks of material misstatement due to fraud (paragraph A30).
43. To ensure that appropriate visibility is given to the importance of considering possible dominant influence when evaluating whether fraud risk factors are present, the IAASB retained the reference to dominant influence in the requirement addressing the identification of fraud risk factors. The IAASB believes that this, together with the more prominent positioning of the guidance on dominant influence in paragraph A6 and the further explanations in paragraphs A29-A30, will ensure that the issue of dominant influence is sufficiently emphasized in the ISA for auditors’ consideration.
44. Finally, the IAASB did not agree with the suggestion that the guidance on dominant influence should be moved to ISA 240 (Redrafted) given that the issue of dominant

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<sup>6</sup> This reference has been retained in paragraph 19 of the ISA.

influence is especially relevant to related parties, and that the linkage between this ISA and ISA 240 (Redrafted) has now been well established.

## **Inherent Limitations**

45. Paragraph 7 of the Re-ED 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. Some respondents 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 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 suggested that the procedures set out in the Re-ED, 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, the respondent 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 considerable risk that related parties, or related party relationships or transactions, might not be identified. Another respondent 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 took an opposite view, arguing that the Re-ED 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.
48. CAG Representatives were generally supportive of the approach taken in the Re-ED.

## **IAASB Decision**

49. The IAASB noted that in finalizing the Re-ED, it had concluded that it is important to highlight the inherent limitations on the auditor's ability to identify related party relationships and transactions because of the need to emphasize the particular skepticism required in the context of related parties. The IAASB, however, agreed that the tone of this discussion in the ISA should be appropriately balanced. The IAASB believes that the views expressed by the respondents above represent the two opposing sides on this issue and do not present an overwhelming case for change in either direction. Accordingly, the IAASB determined that the approach taken to describing inherent limitations should remain

unchanged in the ISA. The IAASB nevertheless made a minor clarification in paragraph 6 of the ISA to indicate that it is the *potential effects* of inherent limitations that are greater, as opposed to the inherent limitations themselves.

## **Frameworks that Deal with Related Parties Adequately and Those that Do Not**

50. Paragraphs 14 and 15 of the Re-ED 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.
51. Several respondents commented that the distinction between these two proposed requirements was very subtle and that it would present practical difficulties for auditors in interpreting the requirements. In particular, they noted that in practice, a requirement to inquire into the nature of any “business” between the parties (paragraph 15(b) of the Re-ED) would likely result in inquiries into the nature of the relationships and transactions (paragraph 14(b) of the Re-ED). In addition, they commented that the requirements were not truly mutually exclusive because under the condition precedent in paragraph 15 of the Re-ED, minimal related party requirements are still related party requirements and so these cases would fall under the scope of paragraph 14 of the Re-ED.
52. A few other respondents suggested that differentiating between the requirements as proposed in the Re-ED 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.

## IAASB Decisions

53. The IAASB's original intention behind paragraph 15 of the Re-ED 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 implemented the information systems necessary to identify all related party relationships and transactions. Given the revised approach to the related party definition, however, the IAASB 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 significantly influence the entity, as reflected in the different procedures in paragraphs 14 and 15 of the Re-ED.
54. The IAASB therefore accepted 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 of the ISA). The IAASB 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.
55. In the specific case where the framework has not established any related party requirements, the IAASB believes that the entity may not have the necessary information systems in place to identify related parties. Under these circumstances, it is possible that management may not be aware of the existence of all related parties. Nevertheless, the requirement to make the inquiries specified by paragraph 13 of the ISA would still apply because management may be aware of parties that meet the related party definition set out in the ISA. In such a case, however, the IAASB agreed that the auditor's inquiries regarding the identity of the entity's related parties would likely form part of the auditor's risk assessment procedures and related activities performed in accordance with ISA 315 (Redrafted)<sup>7</sup> 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.

The IAASB determined that this explanation should be provided as part of guidance in the ISA (see paragraph A12).

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<sup>7</sup> ISA 315 (Redrafted), "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment."

## Inspection of Documents

56. Paragraph 19 of the Re-ED 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.
57. Several respondents commented that this proposed requirement was inconsistent with the risk-based approach underlying the ISAs. They were also concerned about making the proposed ISA overly specific and prescriptive, and suggested that there is little justification for *requiring* those specific documents to be inspected as opposed to the other types of documents set out in paragraph A19 of the Re-ED. 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. Others were of the view that the intent of the guidance in paragraph A19 of the Re-ED was unclear as it did not provide criteria that the auditor would apply in determining whether or not to inspect the documents listed.
58. Some of the respondents suggested that the auditor should determine the documents to inspect based on an assessment of the risk that management has failed to identify all related parties. A few suggested that 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 as illustration, whereas others suggested that list of documents proposed in the Requirements section should be supplemented by other types of documents such as regulatory filings, tax returns, and specific significant contracts and agreements outside the normal course of business. It was also suggested that ISA 550 (Revised and Redrafted) is an inappropriate ISA for a general requirement to inspect minutes of meetings of shareholders and of those charged with governance, and that a conforming amendment should be made to ISA 315 (Redrafted) to require the auditor to inspect these documents as part of the auditor's risk assessment procedures.
59. One respondent commented that the Re-ED appeared to have established a more modest standard for the identification and auditing of related party transactions compared with the first exposure draft. It noted, in particular, that while inquiries of management are required under both exposure drafts, it appeared that the records that were provided as two presumptively mandatory examples in the first exposure draft had now become the only documents the auditor is specifically required to review. The respondent was of the view 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."

## IAASB Decisions

60. The IAASB noted that most of the respondents' concerns were voiced during the first consultation. The approach set out in the Re-ED was 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 pertinent information on related party relationships and transactions.

61. The IAASB, however, acknowledged the concern that the approach set out in the Re-ED appeared to be less stringent than that set out in the first exposure draft. Nevertheless, the IAASB believes 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 many respondents to the first consultation acknowledged, the auditor's search for related parties and related party transactions cannot be open-ended and limitless. In the light of this, the IAASB determined that the requirement to inspect documents in paragraph 15 of the ISA should include a more active obligation to inspect, in addition to the three types of documents already specified, *such other records or documents as the auditor considers necessary in the circumstances of the entity*.
62. With regard to the list of documents set out in the application material (paragraph A22 of the ISA), the IAASB did not agree that the ISA should specify criteria for when the auditor should inspect them. The IAASB noted that the list is intended to illustrate the types of documents that the auditor may inspect during the audit that may provide information about related party relationships and transactions. To clarify this, the IAASB has positioned the guidance as application material to the requirement for the auditor to remain alert, but with a further emphasis in the requirement that the auditor remain alert, *when inspecting records or documents*, for related party information that management has not previously identified or disclosed to the auditor (see paragraph 15 of the ISA).

## **Matters to be Treated as Significant Risks**

### **Significant Related Party Transactions outside the Normal Course of Business**

63. The Re-ED proposed to require the auditor to treat as a significant risk identified significant related party transactions outside the normal course of business. One respondent 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).

#### *IAASB Decision*

64. The IAASB believes that its original view remains valid. Under ISA 315 (Redrafted), 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 IAASB'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 be no 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 IAASB determined that the auditor should treat such transactions as giving rise to significant risks by default (see paragraph 18 of the ISA).

### **Arm's Length Assertions**

65. Paragraph 21 of the Re-ED 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.
66. Many respondents disagreed with this proposal. They noted 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 unlikely to represent higher inherent risks. The respondents thus argued that an arm's length assertion regarding such transactions would not represent a higher inherent risk in all circumstances. They also commented that in practical terms, the proposed requirement could capture a high volume of routine transactions with related parties that would not constitute a significant risk. In addition, they felt that the determination of significant risks in accordance with ISA 315 (Redrafted) is a matter for the auditor's professional judgment because it should take into account the consideration of many factors.
67. Most of these respondents suggested that the requirement should be deleted. One respondent suggested that the requirement should be revised to establish a *presumption* of significant risk.

### *IAASB Decisions*

68. The IAASB acknowledged the significant concerns raised and accepted that this requirement could cause practical difficulties. The IAASB believes that in these circumstances, it would be more appropriate to adopt an approach based on evaluating the relevant factors, as ISA 315 (Redrafted) intends, in determining whether a significant risk is present. Accordingly, the IAASB deleted the proposed requirement.
69. Nevertheless, the IAASB retained the guidance in paragraph A42 of the ISA that emphasizes the practical difficulties the auditor may experience in obtaining audit evidence that all aspects of a related party transaction are equivalent to those prevailing in an arm's length transaction. The guidance adds that, because of this, there is a risk that management's arm's length assertion may be materially misstated.
70. The IAASB 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.

## Previously Unidentified or Undisclosed Related Party Relationships and Transactions

71. For engagements where the applicable financial reporting framework establishes related party requirements, paragraph 23 of the Re-ED 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.
72. Some respondents suggested that these required procedures should apply to *all* engagements, regardless of whether the framework establishes related party requirements. One of them, 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.
73. Another respondent noted that the list of required actions did not include what the auditor should do to investigate whether *other* unidentified or undisclosed related parties or significant related party transactions might exist.

### IAASB Decisions

74. The IAASB noted that the main reason why these procedures were limited to circumstances where the framework has established related party requirements is that if the framework does not deal with related parties, 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 may not be fully familiar with the auditor's related party definition in this situation and may therefore

not identify related parties or related party transactions for disclosure to the auditor. 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.

75. The IAASB, 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. In addition, with regard to the requirement to communicate with those charged with governance under procedure (e), the IAASB agreed that this was effectively already covered by the requirement in paragraph 28 of the Re-ED for the auditor to communicate significant related party matters identified during the audit with those charged with governance. Accordingly, the IAASB determined that the point should be dealt with in the guidance pertaining to the latter requirement (see first bullet of paragraph A50 in the ISA).
76. Finally, the IAASB accepted that it would be appropriate for the ISA to specify the action the auditor should take regarding the existence of other unidentified or undisclosed related parties or significant related party transactions. The IAASB determined that this action will involve a reconsideration of the risk that other unidentified or undisclosed related parties or significant related party transactions may exist, and the performance of additional audit procedures as necessary (see paragraph 22(d) of the ISA).

### **Implicit Arm's Length Assertions**

77. When the first exposure draft was issued, 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 normal market conditions. The IAASB noted that a consequence of this requirement is that if the entity did not disclose related party transactions in the financial statements, there would be an implicit assertion that they were conducted under normal market conditions (arm's length terms). The respondents suggested that the proposed ISA address this situation.
78. 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 audit evidence that they were conducted under normal market conditions. The IAASB asked for respondents' views as to whether the proposed ISA should address this situation and, if so, how it should do so.
79. A majority of the respondents 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, that is, 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.

80. 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.
81. A minority of respondents 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 to auditing such assertions. 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 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.

### **IAASB Decisions**

82. The IAASB agreed with the majority of respondents who suggested that there should be no specific requirements in the ISA to deal with implicit arm's length assertions, and 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. The IAASB also agreed that the requirement to obtain sufficient appropriate audit evidence about an arm's length assertion (paragraph 24 of the ISA) should remain framework neutral and not specifically refer to implicit or explicit assertions.
83. The IAASB was, however, persuaded by the arguments from some respondents that it would be in the public interest for the ISA to highlight the fact that arm's length assertions may also be implicit, given that this may have significant implications for the scope and extent of the auditor's work effort in practice. The IAASB believes that doing so will appropriately raise awareness of the issue without undermining the framework neutrality of the ISA. Accordingly, brief guidance to that effect has been provided in paragraph A45 of the ISA.

## Written Representations

84. In circumstances where the applicable financial reporting framework establishes related party requirements, paragraph 27 of the Re-ED 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 regarding the entity's related party relationships and transactions.
85. Several respondents 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 in the ISA. The respondents were of the view that this would be consistent with achieving the objectives set out in the Re-ED. In particular, they suggested that in the absence of specific related party requirements 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 be particularly important given the inherent limitations facing the auditor when auditing related party transactions. They therefore suggested that a principles-based requirement should be established that would apply in all circumstances.

## IAASB Decisions

86. The IAASB had discussed the issue of the scope of written representations at length in finalizing the Re-ED. Although the respondents' arguments have merit, the IAASB believes 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 unworkable. In particular, there would be a significant risk that management would decline to provide such representations on the ground that they do not fully understand the definition of a related party for audit purposes, thus leading to the significant possibility that the auditor would have to modify the audit opinion on scope limitation grounds.
87. Nevertheless, the IAASB believes 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 IAASB determined that no change should be made to the requirement for written representations.

## Special Purpose Entities

88. One respondent noted that the Re-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.

## IAASB Decisions

89. The IAASB noted that although SPEs are a current issue of the day, there might well be other structures that could be devised in future that could also give rise to related party

issues. The IAASB is of 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 determined that it would be unnecessary to emphasize SPEs in the requirements of the ISA.

90. Nevertheless, the IAASB agreed that it would be appropriate to place an added emphasis on SPEs in ISA 315 (Redrafted), through a conforming amendment to paragraph 11(b)(iii) of that ISA, to highlight the need for the auditor to consider investments in SPEs in the context of the general requirement for the auditor to obtain an understanding of the types of investments the entity is making and plans to make. The IAASB also determined that general guidance on the nature of an SPE should be provided in ISA 315 (Redrafted) in support of that conforming amendment (see new paragraphs A23a-A23b added to ISA 315 (Redrafted)).
91. In addition, to further clarify the relevance of SPEs in relation to related parties, the IAASB has added guidance in paragraph A7 of the ISA in the context of the related party definition to explain that an SPE may, in some circumstances, be a related party because the entity may in substance control it even if the entity owns little or none of the SPE's equity. Finally, the IAASB included a further mention of SPEs in the third bullet of paragraph A9 of the ISA in the context of matters that may be addressed in the engagement team discussion.
92. The IAASB believes that these additions appropriately strengthen the considerations needed with regard to SPEs without unduly over-emphasizing such types of structures to the detriment of other important areas of focus in the audit.

## **Group Audits**

93. One respondent suggested that the ISA should differentiate between the extent of work effort involved when the auditor is engaged to audit consolidation packages in group audits, and when 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 suggested that in such circumstances, the ISA should only apply to related party transactions that are outside the group.

## **IAASB Decision**

94. The IAASB noted that ISAs do not as such deal with audits of packages for consolidation, the scope of which is for the group auditor to determine. Where the entity preparing the consolidation package is also issuing its own financial statements, the ISAs would need to

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apply in full. Accordingly, the IAASB determined that there is no need to refer to consolidation packages in the ISA.