

**IAASB CAG REFERENCE PAPER**  
**IAASB CAG Agenda (September 2006)**  
**Agenda Item N.1**  
**Related Parties—Revised Post-ED Draft – September 2006 IAASB Agenda Item 7-B**

**PROPOSED INTERNATIONAL STANDARD ON AUDITING 550**  
**(REVISED)**

**RELATED PARTIES**

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

**[Revised Post-ED Draft (Clean)]**

**CONTENTS**

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	Paragraph
<b>Introduction</b>	
Scope of this ISA .....	1
Related Parties in the Context of an Audit of Financial Statements .....	2-6
Effective Date .....	7
<b>Objective</b> .....	8
<b>Definitions</b> .....	9-10
<b>Requirements</b>	
Risk Assessment Procedures and Related Activities .....	11-16
Identification and Assessment of the Risks of Material Misstatement Resulting from Related Parties .....	17-18
Responses to the Risks of Material Misstatement Resulting from Related Parties .....	19-22
Evaluation of Related Party Relationships, Transactions and Disclosures .....	23
Written Representations .....	24
Communication with Those Charged with Governance .....	25
Documentation .....	26
<b>Application and Other Explanatory Material</b>	
Risk Assessment Procedures and Related Activities .....	A1-A22
Identification and Assessment of the Risks of Material Misstatement Resulting from Related Parties .....	A23-A26
Responses to the Risks of Material Misstatement Resulting from Related Parties .....	A27-A38
Evaluation of Related Party Relationships, Transactions and Disclosures .....	A39-A40
Written Representations .....	A41-A44
Communication with Those Charged with Governance .....	A45

## IAASB CAG REFERENCE PAPER

### IAASB CAG Agenda (September 2006)

#### Agenda Item N.1

#### Related Parties—Revised Post-ED Draft - September 2006 IAASB Agenda Item 7-B

## Introduction

### Scope of this ISA

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

### Related Parties in the Context of an Audit of Financial Statements

2. Related party transactions are often a normal part of business. They commonly involve components within a group pursuing transactions with each other to further the overall financial objectives of the group. They may also involve management transacting with the entity for legitimate purposes. Related party transactions often carry no higher risk of material misstatement of the financial statements than transactions with unrelated parties, particularly if they are of a routine nature. However, because of the nature of related party relationships, related party transactions may in some circumstances give rise to higher risks of material misstatement of the financial statements compared with transactions between unrelated parties. **[ISSUE A]**
3. The risk of material misstatement of the financial statements resulting from the entity not identifying, or not appropriately accounting for or disclosing, related party relationships or transactions may be higher than the risk of material misstatement resulting from other transactions for a number of reasons, including the following:
  - (a) Related parties may operate through an extensive and complex range of relationships and structures, and may enter into complex transactions;
  - (b) Related party transactions may be informal; for example, in some entities, there may be relationships and transactions involving family members of management that are not fully documented or formally approved;
  - (c) Information systems may be ineffective at identifying or summarizing transactions and outstanding balances between an entity and its related parties;
  - (d) Management may be unaware of the existence of related parties or related party transactions, especially if management has incomplete knowledge of the related party definitions (or descriptions) and requirements of the applicable financial reporting framework; and
  - (e) Related party transactions may not be conducted under normal commercial terms and conditions; for example, some related party transactions may be conducted with no exchange of consideration.

## IAASB CAG REFERENCE PAPER

### IAASB CAG Agenda (September 2006)

#### Agenda Item N.1

#### Related Parties—Revised Post-ED Draft – September 2006 IAASB Agenda Item 7-B

In addition, related party relationships may present a greater opportunity for collusion, concealment or manipulation by management, resulting in a higher risk of fraud, especially if the related parties are not disclosed to the auditor.

4. For these reasons, there is an inherent limitation regarding the auditor's ability to identify related party relationships and transactions. Nevertheless, the requirements of this ISA provide a reasonable basis for obtaining sufficient appropriate audit evidence about the accounting for, and disclosure of, related party relationships and transactions. **[ISSUE B]**
5. Financial reporting frameworks ordinarily do not require related party transactions to be accounted for differently from transactions between unrelated parties. They may, however, establish disclosure requirements for related party relationships and transactions to enable users of the financial statements to understand their nature and their actual or potential effects on the financial statements.
6. Some financial reporting frameworks may address related party relationships and transactions only to a limited extent, for example, where the frameworks have been designed for special purpose financial statements or where disclosure of related party relationships and transactions would be considered impracticable or meaningless because of significant governmental ownership. Nevertheless, even when the applicable financial reporting framework establishes limited or no related party requirements, the requirements and guidance in this ISA are relevant in fulfilling the auditor's responsibilities relating to fraud in the audit of the financial statements. **[ISSUE C]**

#### Effective Date

7. This ISA is effective for audits of financial statements for periods beginning on or after [date].

#### Objective

8. The objective of the auditor is to obtain sufficient appropriate audit evidence about whether related party relationships and transactions have been properly accounted for and disclosed in the financial statements.

#### Definitions

9. Financial reporting frameworks often define or describe when parties are considered to be related to each other for the purposes of accounting for and disclosing related party relationships and transactions. Therefore, if the applicable financial reporting framework establishes related party requirements, the related party definitions or descriptions set out in the framework apply for the purposes of identifying, assessing and responding to the risks of material misstatement resulting from related parties. However, regardless of whether the applicable financial reporting framework establishes related party requirements, the auditor has responsibilities relating to fraud when performing the audit. Accordingly, for the purpose of addressing the risks of material misstatement due to fraud resulting from related parties, regard is given to parties that have control or significant influence over the entity, or over which the entity has control or significant influence, regardless of any related party definitions or

## IAASB CAG REFERENCE PAPER

### IAASB CAG Agenda (September 2006)

#### Agenda Item N.1

#### Related Parties—Revised Post-ED Draft - September 2006 IAASB Agenda Item 7-B

descriptions in the applicable financial reporting framework. In this regard, control or significant influence is ordinarily evidenced through the extent of a party's equity interest in, or voting power over, an entity. Other relationships that commonly involve control or significant influence include the following:

- (a) The party forms part of the management or those charged with governance of the entity;
- (b) The party is a close family member of any individual referred to in subparagraph (a);
- (c) The party has a significant business relationship with any individual referred to in subparagraph (a); or
- (d) There is evidence that the party exerts dominant influence over the entity. **[ISSUE C]**

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

- (a) "Arm's length assertion" – an assertion that a transaction was conducted on such terms and conditions as between a willing buyer and a willing seller acting as if they were unrelated and pursuing their own best interests;
- (b) "Conflict of interest" – in relation to management and those charged with governance, a situation that arises from (i) being in a position to advance their own personal interests contrary to their fiduciary responsibilities to the entity, or (ii) having competing responsibilities to two or more entities;
- (c) "Dominant influence" – domination of the entity by a single individual or small group of individuals. Such an individual or group of individuals may have no official role within the entity; and **[ISSUE E]**
- (d) "Material misstatement resulting from related parties" – a material misstatement of the financial statements due to fraud or error arising from the failure to appropriately account for or disclose related party relationships, transactions or balances.

## Requirements

### Risk Assessment Procedures and Related Activities **[ISSUE A]**

11. When performing risk assessment procedures and related activities to obtain an understanding of the entity and its environment, including its internal control, as required by ISA 315, the auditor shall perform the procedures and related activities set out in paragraphs 12 to 16 to obtain information in identifying the risks of material misstatement resulting from related parties.

### *Discussion Among the Engagement Team, Inquiries of Management and Sharing of Related Party Information*

12. The discussion among members of the engagement team required by ISAs 240 and 315 shall include specific consideration of the susceptibility of the financial statements to: (Ref: Para. A1)

## IAASB CAG REFERENCE PAPER

### IAASB CAG Agenda (September 2006)

#### Agenda Item N.1

#### Related Parties—Revised Post-ED Draft – September 2006 IAASB Agenda Item 7-B

- (a) Material misstatements due to error that could result from related party relationships or transactions not being appropriately accounted for or disclosed in accordance with the applicable financial reporting framework; and (Ref: Para. A2)
  - (b) Material misstatements due to fraud that could be committed through related party relationships, including those relationships referred to in paragraph 9. (Ref: Para. A3) **[ISSUE C]**
- 13. To obtain an understanding of the entity's related party relationships and transactions, the auditor shall make inquiries of management regarding: (Ref: Para. A4) **[ISSUE A]**
  - (a) The identity of the entity's related parties, as defined or described by the applicable financial reporting framework; (Ref: Para. A5)
  - (b) The nature of the related party relationships, including how the entity is controlled or significantly influenced, and how it controls or significantly influences other related parties; and (Ref: Para. A6-A7)
  - (c) Whether there were any transactions with related parties and such other parties as would fall under the relationships referred to in paragraph 9, and if so, understand broadly the nature of these transactions and their business rationale. (Ref: Para. A8-A10) **[ISSUE C]**
- 14. The auditor shall perform appropriate procedures, including making inquiries of management, to obtain an understanding of the controls (including the control environment and governance processes) that management has established to identify, account for, and disclose related party relationships and transactions in accordance with the applicable financial reporting framework. (Ref: Para. A11-A17)
- 15. The auditor shall share information about the entity's related party relationships with the other members of the engagement team to enable them to be alert to the effects of these relationships throughout the audit.

#### *Maintaining Alertness for Related Party Information When Performing the Audit* **[ISSUES A, D]**

- 16. During the audit, the auditor shall be alert for transactions or other information that may be indicative of the existence of previously unidentified or undisclosed related party relationships or transactions. In addition, the auditor shall inspect the following documents for such information:
  - (a) Bank and legal confirmations, if obtained by the auditor; and
  - (b) Minutes of meetings of shareholders and of those charged with governance, if such meetings were held during the period. (Ref: Para. A18-A22)

If the auditor identifies such transactions or other information, the auditor shall investigate whether the related circumstances indicate the existence of previously unidentified or undisclosed related parties.

## IAASB CAG REFERENCE PAPER

### IAASB CAG Agenda (September 2006)

#### Agenda Item N.1

#### Related Parties—Revised Post-ED Draft - September 2006 IAASB Agenda Item 7-B

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

17. In identifying and assessing the risks of material misstatement required by ISA 315, the auditor shall determine whether risks of material misstatement arise from one or more of the following circumstances, and if so, whether those risks are significant risks: (Ref: Para. A23-A24, A26)
- (a) Management not identifying or disclosing to the auditor one or more of the entity's related parties;
  - (b) Management not identifying or disclosing to the auditor transactions with identified related parties; or
  - (c) Management not appropriately accounting for or disclosing identified related party relationships or transactions in accordance with the applicable financial reporting framework.
18. The auditor shall treat at least the following as circumstances giving rise to significant risks:
- (a) Management has made an assertion in the financial statements (whether explicitly or implicitly) that a related party transaction was conducted at arm's length and management finds it difficult to substantiate this assertion; and (Ref: Para. A25)
  - (b) The identification of previously unidentified or undisclosed related party relationships or significant related party transactions during the audit.

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

19. In responding to assessed risks as required by ISA 330, the auditor shall design and perform further audit procedures that are responsive to the assessed risks of material misstatement resulting from related parties. (Ref: Para. A27-A34) **ISSUE A**

#### *Arm's Length Assertions*

20. If the auditor is unable to obtain sufficient appropriate audit evidence about an arm's length assertion, the auditor shall request management to delete or correct the assertion as appropriate. If management disagrees, the auditor shall consider the implications on the audit, including on the auditor's report. (Ref: Para. A35)

#### *Significant Non-Routine Related Party Transactions*

21. For significant non-routine related party transactions identified during the audit, the auditor shall:
- (a) Evaluate whether their terms and the way they have been accounted for are consistent with management's explanation of their business rationale; and
  - (b) Obtain evidence that they have been appropriately authorized and approved. (Ref: Para. A36-A37) **ISSUE A**

## **IAASB CAG REFERENCE PAPER**

### **IAASB CAG Agenda (September 2006)**

#### **Agenda Item N.1**

#### **Related Parties—Revised Post-ED Draft – September 2006 IAASB Agenda Item 7-B**

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

22. If the auditor identifies related parties or significant related party transactions not previously identified or disclosed by management, the auditor shall:
- (a) Promptly communicate this information to the other members of the engagement team to enable them to determine whether it 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 transactions with the newly identified related parties for the auditor's further evaluation;
  - (c) Investigate 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; and
  - (d) If the non-identification or non-disclosure appears intentional, (i) communicate this information to those charged with governance (unless all of them are part of management), and (ii) evaluate the implications on the audit. (Ref: Para. A38)

##### **Evaluation of Related Party Relationships, Transactions and Disclosures**

23. In forming the opinion on the financial statements, the auditor shall evaluate whether the entity's related party relationships and transactions have been properly accounted for and disclosed in accordance with the applicable financial reporting framework. (Ref: Para. A39-A40)

##### **Written Representations**

24. The auditor shall obtain written representations from management and, where appropriate, those charged with governance concerning:
- (a) Whether the information they have provided to the auditor regarding the identity of the entity's related parties and its related party relationships and transactions is complete and accurate;
  - (b) Whether related party transactions and the effects of related party relationships have been appropriately accounted for, including whether the financial statements reflect the economic substance of these relationships and transactions; and
  - (c) Whether the related party disclosures in the financial statements are appropriate. (Ref: Para. A41-A44)

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

25. Unless all of those charged with governance are involved in managing the entity, the auditor shall communicate with them significant issues identified during the audit regarding the entity's related party relationships and transactions, including issues that the auditor perceives as involving conflicts of interest. (Ref: Para. A45)

## IAASB CAG REFERENCE PAPER

### IAASB CAG Agenda (September 2006)

#### Agenda Item N.1

#### Related Parties—Revised Post-ED Draft - September 2006 IAASB Agenda Item 7-B

#### Documentation

26. The auditor shall document the identity of the entity's related parties and the nature of its related party relationships.

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### Application and Other Explanatory Material

#### Risk Assessment Procedures and Related Activities

*Discussion Among the Engagement Team, Inquiries of Management and Sharing of Related Party Information* (Ref: Para. 12-14)

A1. Matters that may be addressed in the discussion among the engagement team include:

- The nature and extent of the entity's related party relationships and transactions.
- An emphasis on the importance of maintaining an attitude of professional skepticism throughout the audit regarding the potential for material misstatement resulting from related parties.
- The circumstances or conditions of the entity that may indicate the existence of unidentified or undisclosed related party relationships or transactions (for example, a complex organizational structure or an inadequate information system).
- The importance that management and those charged with governance attach to the identification, appropriate accounting for, and disclosure of related party relationships and transactions, and the related risk of management override of relevant controls.

Further, the discussion of such matters as those set out in paragraph A11 of ISA 240 in the context of fraud may include specific consideration of how related parties may be involved in fraud. For example, a consideration of circumstances that might be indicative of earnings management that could result in fraudulent financial reporting may include consideration of how special purpose entities controlled by management might be used to facilitate earnings management.

- A2. Even if the applicable financial reporting framework establishes no specific accounting or disclosure requirements for related party transactions, it is important to understand the entity's related party relationships and transactions because these may have an effect on the application of other requirements of the framework. In particular, the nature of the related party relationships may be relevant in determining the appropriate accounting for transactions between the entity and its related parties based on economic substance instead of legal form.
- A3. The definitions or descriptions of related parties in the applicable financial reporting framework provide the relevant context for the discussion of the susceptibility of the entity's financial statements to material misstatements due to error resulting from related parties. However, the relevant context when discussing the susceptibility of the entity's financial statements to material misstatements due to fraud committed through related party



**IAASB CAG REFERENCE PAPER**

**IAASB CAG Agenda (September 2006)**  
**Agenda Item N.1**  
**Related Parties—Revised Post-ED Draft – September 2006 IAASB Agenda Item 7-B**

relationships is that provided by those relationships referred to in paragraph 9. This may be particularly relevant where the applicable financial reporting framework does not address related party transactions or only does so to a limited extent.

- A4. Inquiry of management provides the primary means through which the auditor may obtain an understanding of the entity's related party relationships and transactions. The auditor may also perform other procedures considered appropriate for this purpose.
- A5. The auditor may obtain some of the information about the identity of the entity's related parties through inquiries of management during the engagement acceptance or continuance process.
- A6. ISA 315 requires the auditor to obtain an understanding of the nature of the entity, including its ownership and governance. Control or significant influence may be exerted directly or indirectly through one or more intermediaries. Obtaining an understanding of how control or significant influence operates within a given related party relationship may assist the auditor in better understanding the effects or potential effects of the relationship. In particular, the existence of one or more of the relationships referred to in subparagraphs 9(a)-(d) may give rise to risks of material misstatement due to fraud, and thus influence the nature, timing and extent of the auditor's procedures in the context of the auditor's responsibilities relating to fraud. **[ISSUE C]**
- A7. Some circumstances may make it difficult for the auditor to obtain a full understanding of the nature of the related party relationships, for example:
- A complex shareholding structure, such as one involving trusts, foundations or governmental bodies.
  - The sharing of control over the related party with external parties.
  - The location of shareholder or other relevant records in a foreign jurisdiction.
- These circumstances increase the risk that material misstatements resulting from related parties may not be detected.
- A8. Inquiring into the business rationale of the entity's related party transactions enables the auditor to evaluate whether their effects give rise to risks of material misstatement in the financial statements. Risks may arise particularly if the forms of the transactions do not represent their true economic substance. For example, the sale of property to a major shareholder at a price above or below fair market value may constitute a contribution or return of capital or the payment of a dividend in substance, rather than a transaction involving a profit or loss for the entity.
- A9. In obtaining an understanding of the business rationale of a related party transaction, the auditor may consider the following:
- Whether the transaction:

## **IAASB CAG REFERENCE PAPER**

### **IAASB CAG Agenda (September 2006)**

#### **Agenda Item N.1**

#### **Related Parties—Revised Post-ED Draft - September 2006 IAASB Agenda Item 7-B**

- Is overly complex (for example, it may involve multiple related parties within a consolidated group, or unrelated third parties, or several iterations of the recorded transaction);
  - Has unusual terms of trade, such as unusual prices, interest rates, guarantees and repayment terms;
  - Lacks an apparent logical business reason for its occurrence;
  - Involves previously unidentified related parties; or
  - Is processed in an unusual manner.
  - Whether management has discussed the nature of, and accounting for, such a transaction with those charged with governance.
  - Whether management is placing more emphasis on a particular accounting treatment rather than considering the underlying economics of the transaction.
  - Whether the transaction has been appropriately authorized and approved.
- A10. The auditor may also seek to understand the business rationale of the related party transactions from the related parties' perspectives, as this may help the auditor to better understand the substance of the transactions and why they were carried out. A business rationale from the related parties' perspectives that appears inconsistent with the nature of their businesses may represent a factor indicative of risks of material misstatement.
- A11. As indicated in ISA 200, ["Overall Objective of the Independent Auditor, and General Concepts Relevant to an Audit of Financial Statements,"] the responsibility for the preparation and presentation of the financial statements in accordance with the applicable financial reporting framework is that of the entity's management, with oversight from those charged with governance. To be able to fulfill such responsibility, management has to design, implement and maintain adequate controls over related party relationships and transactions to ensure that these are properly accounted for and disclosed in accordance with the framework. In their oversight role, those charged with governance are responsible for monitoring how management is discharging its responsibility for such controls. They are also responsible for ensuring that they receive all necessary information from management to understand the nature and business rationale of the entity's related party relationships and its significant related party transactions.
- A12. In obtaining an understanding of the control environment in accordance with ISA 315, the auditor may consider features of the control environment relevant in mitigating the risks of material misstatement resulting from related parties, such as:
- Internal ethical codes, appropriately communicated to the entity's personnel and enforced, governing the circumstances in which the entity may enter into specific types of related party transactions.

## **IAASB CAG REFERENCE PAPER**

### **IAASB CAG Agenda (September 2006)**

#### **Agenda Item N.1**

#### **Related Parties—Revised Post-ED Draft – September 2006 IAASB Agenda Item 7-B**

- Policies and procedures for open and timely disclosure of the interests that management and those charged with governance have in related party transactions.
- The assignment of responsibilities within the entity for identifying, recording, summarizing, and disclosing related party transactions.
- Timely disclosure and discussion between management and those charged with governance of significant non-routine related party transactions.
- Clear guidelines for the approval of related party transactions involving actual or perceived conflicts of interest.
- Periodic reviews by internal audit, where applicable.
- Proactive action taken by management to resolve related party disclosure issues, such as by seeking advice from the auditor or external legal counsel.
- The existence of whistle-blowing policies and procedures, where applicable.

A13. Controls over related party relationships and transactions within some entities may be weak, ineffective or non-existent for a number of reasons, such as:

- The low importance attached by management to identifying and disclosing related party relationships and transactions.
- The lack of appropriate oversight by those charged with governance.
- An intentional disregard for such controls because related party disclosures may reveal information that management considers sensitive.
- An insufficient understanding by management of the disclosure requirements of the applicable financial reporting framework.
- The absence of disclosure requirements under the applicable financial reporting framework.

A14. The absence of effective controls over related party relationships and transactions increases the risks that management will not identify, appropriately account for, or disclose them. This may be particularly the case in a smaller entity environment, where management and those charged with governance are often the same. In such circumstances, the absence of independent oversight and approval of significant related party transactions increases the risks of material misstatement resulting from related parties.

A15. The auditor may obtain an understanding of the oversight exercised by those charged with governance through inquiries of them, or observing or reading minutes of meetings at which related party transactions are discussed and approved. This enables the auditor to gain an insight into the understanding those charged with governance have of the entity's related party relationships and transactions, the adequacy of their oversight, and the susceptibility of the entity to management override of controls. In obtaining an understanding of such oversight, the

## IAASB CAG REFERENCE PAPER

### IAASB CAG Agenda (September 2006)

#### Agenda Item N.1

#### Related Parties—Revised Post-ED Draft - September 2006 IAASB Agenda Item 7-B

auditor may consider such matters as whether those charged with governance have challenged the business rationale of the related party transactions (for example, by seeking advice from external professional advisors), or by establishing subcommittees comprising individuals independent of management to evaluate and recommend the related party transactions for approval.

A16. As discussed in ISA 240, fraudulent financial reporting and misappropriation of assets often arise through management override of controls that otherwise appear to be operating effectively. The risk of management override of controls is higher if management has related party relationships with parties with which the entity does business because these relationships may present management with greater incentives and opportunities to perpetrate fraud. For example, management's financial interests in certain related parties may provide incentives for management to override controls by (a) directing the entity, against its interests, to conclude transactions benefiting the related parties, or (b) colluding with those parties or controlling their actions. Examples of possible fraud include:

- Creating fictitious terms of transactions with related parties designed to misrepresent the business rationale of these transactions.
- Fraudulently organizing the transfer of assets from or to management or others at amounts significantly above or below market value.
- Engaging in complex transactions with related parties, such as special-purpose entities,<sup>1</sup> that are structured to misrepresent the financial position or financial performance of the entity.

#### Considerations Specific to Smaller Entities

A17. As discussed in ISA 315, the control environment in small entities is likely to be different from that in larger entities. In particular, those charged with governance in small entities may not include an independent or outside member, and the role of governance may be undertaken directly by the owner-manager where no other owners exist. Consistent with their simpler businesses, smaller entities may have fewer or no processes in place for dealing with related party relationships and transactions. Instead, the owner-manager in a small business may mitigate some of the risks that may arise from related party transactions through active involvement in all the main aspects of the transactions. Accordingly, for such entities, the auditor may only be able to obtain an understanding of the related party relationships and transactions mainly through inquiry of management.

#### *Maintaining Alertness for Related Party Information When Performing the Audit* (Ref: Para. 16)

A18. The determination of which transactions may be indicative of the existence of previously unidentified or undisclosed related party relationships or transactions is a matter of the

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<sup>1</sup> Special-purpose entities (sometimes referred to as structured finance entities) are entities that are established for specific limited purposes, such as providing financing, liquidity, hedging or credit support.

## IAASB CAG REFERENCE PAPER

### IAASB CAG Agenda (September 2006)

#### Agenda Item N.1

#### Related Parties—Revised Post-ED Draft – September 2006 IAASB Agenda Item 7-B

auditor's judgment. Such transactions may include those with the following characteristics:

#### **ISSUE D]**

- They arise outside the normal course of business.
- They are undertaken on non-arm's length terms.
- They lack a clear business rationale and give rise to questions of substance over form.
- They arise in unusual conditions or circumstances.
- They are of unusual complexity.
- They have not been processed and approved in accordance with the entity's normal policies and procedures.

A19. Examples of such types of transactions may include:

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

A20. Other information that may be indicative of the existence of previously unidentified or undisclosed related party relationships or transactions may include, for example:

- Guarantees and guarantor relationships.
- The existence of special-purpose entities with which the entity does business.

A21. The auditor may also inspect some or all of the following records or documents in the course of performing other audit procedures, which may provide new information about related party relationships and transactions: **ISSUE F]**

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

## IAASB CAG REFERENCE PAPER

### IAASB CAG Agenda (September 2006)

#### Agenda Item N.1

#### Related Parties—Revised Post-ED Draft - September 2006 IAASB Agenda Item 7-B

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

#### Considerations Specific to Smaller Entities

A22. In a smaller entity environment, not all of the records or documents listed in paragraph A21 will exist. In an audit of a smaller entity, however, the auditor may have more direct contact with the owner-manager than would be the case for audits of larger entities. Accordingly, the auditor may be able to obtain a deeper understanding of related parties through such direct interaction with the owner-manager.

#### Identification and Assessment of the Risks of Material Misstatement Resulting from Related Parties (Ref: Para. 17-18)

A23. If, in carrying out the risk assessment procedures and related activities in relation to related parties, the auditor identifies one or more fraud risk factors, such factors may be considered with other fraud risk factors the auditor may have identified when performing procedures in accordance with ISA 240 to identify and assess the risks of material misstatement due to fraud.

A24. The existence of a party with dominant influence over the entity is a risk factor on its own because such a party has the ability to override management and those charged with governance in significant decisions affecting the entity's business. In the presence of other relevant risk factors, however, the existence of a dominant party may indicate significant risks of material misstatement. For example: **ISSUE E**

- A relatively high turnover of senior management or professional advisors may suggest disagreement over current business practices that might be illegal (e.g. tax evasion) but could satisfy the dominant party's objectives.
- The use of business intermediaries for significant transactions for which there appears to be no clear business justification may suggest that the dominant party could be interested in such transactions through control of such intermediaries for fraudulent purposes.
- Evidence of the dominant party's excessive participation in or preoccupation with the selection of accounting policies or the determination of significant estimates may suggest the possibility of fraudulent financial reporting.

A25. Management may make an explicit arm's length assertion in the entity's related party disclosures by stating or implying that related party transactions were consummated on terms equivalent or similar to those prevailing in transactions between unrelated parties. Where management is required under the applicable financial reporting framework to disclose any

## **IAASB CAG REFERENCE PAPER**

### **IAASB CAG Agenda (September 2006)**

#### **Agenda Item N.1**

#### **Related Parties—Revised Post-ED Draft – September 2006 IAASB Agenda Item 7-B**

related party transactions that were not conducted at arm's length, there is equally an implicit assertion that certain related party transactions were conducted at arm's length if management does not disclose them.

#### **Considerations Specific to Public Sector Entities**

A26. The public sector auditor's responsibility to conduct an audit of the financial statements with a view to expressing an opinion on them may be a result of legislation and regulation, ministerial directives, government policy requirements and resolutions of the legislature applicable to public sector entities or separately covered by the auditor's mandate. Consequently, the public sector auditor's responsibilities may not be limited to addressing the risks of material misstatement resulting from related parties, but may also include a broader responsibility to address the risks of non-compliance with laws and regulations governing public sector bodies, which may lay down specific requirements in the conduct of business with related parties. Further, the public sector auditor may need to have regard to public sector financial reporting requirements for related party relationships and transactions that may differ from those in the private sector.

#### **Responses to the Risks of Material Misstatement Resulting from Related Parties** (Ref: Para. 19-25)

A27. The nature, timing and extent of the further procedures that the auditor may select to respond to the assessed risks of material misstatement resulting from related parties depend upon the nature of those risks and the circumstances of the entity. ISA 330 provides further guidance on considering the nature, timing and extent of further audit procedures.

A28. Examples of substantive procedures that the auditor may perform when the auditor has assessed a significant risk that management has not identified or disclosed to the auditor related party relationships or transactions include:

- Conducting a detailed analysis of accounting records for transactions with (a) specific characteristics, such as terms that deviate significantly from known market terms, or (b) unusual patterns or trends, such as regular advances to a third party. Such an analysis may be facilitated using computer-assisted audit techniques.
- Making inquiries, where practicable and not prohibited by law, regulation or ethical rules, of parties outside the entity who are presumed to have significant knowledge of the entity and its business, such as principal agents, major representatives, consultants, guarantors, or other close business partners.
- Investigating the entity's relationships with major suppliers and customers, such as inquiring of them as to whether they are related, reading their financial statements or other relevant financial information, if available, or inquiring of relevant information sources regarding their ownership.
- Performing substantive analytical procedures on specific classes of transactions, such as lease expense or sales, to identify unusual relationships.
- Performing appropriate background searches using, for example, internet resources.

## IAASB CAG REFERENCE PAPER

### IAASB CAG Agenda (September 2006)

#### Agenda Item N.1

#### Related Parties—Revised Post-ED Draft - September 2006 IAASB Agenda Item 7-B

A29. Examples of substantive procedures that the auditor may perform when the auditor has assessed a significant risk that management has not properly accounted for or, where required by the applicable financial reporting framework, disclosed specific related party transactions, whether due to fraud or error, include:

- Confirming or discussing specific aspects of the transactions with intermediaries such as banks, law firms, guarantors, or agents, where practicable and not prohibited by law, regulation or ethical rules.
- Confirming the purposes, specific terms or amounts of the transactions with the related parties. This procedure may be less effective where the auditor judges that the entity is likely to influence the related parties in their responses to the auditor.
- Where applicable, reading the financial statements or other relevant financial information, if available, of the related parties for evidence of the accounting of the transactions in the related parties' books.

A30. If the auditor has assessed a significant risk of material misstatement due to fraud as a result of the presence of a party with dominant influence over the entity, the auditor may, in addition to the general requirements of ISA 240, perform procedures such as the following to obtain an understanding of the business relationships that such a dominant party may have established directly or indirectly with the entity and to determine the need for further appropriate substantive procedures:

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

A31. In some circumstances, it may not be possible to perform only substantive procedures in relation to the risks of material misstatement resulting from related parties. In such circumstances, the auditor may determine that it is necessary to test the entity's controls over related party relationships and transactions to obtain sufficient appropriate audit evidence about the operating effectiveness of the controls during the period. For example, where inter-company transactions between the entity and its components are numerous and a significant amount of information regarding these transactions is initiated, recorded, processed or reported electronically in an integrated system, the auditor may determine that it is not possible to design effective substantive procedures that by themselves would reduce the risks of material misstatement resulting from these transactions to an acceptably low level. In such a case, audit evidence about the inter-company transactions may be available only in electronic form, and its sufficiency and appropriateness will depend upon the effectiveness of the controls over its accuracy and completeness.



## IAASB CAG REFERENCE PAPER

### IAASB CAG Agenda (September 2006)

#### Agenda Item N.1

#### Related Parties—Revised Post-ED Draft – September 2006 IAASB Agenda Item 7-B

A32. The auditor may also plan to rely on the operating effectiveness of controls where these are designed to mitigate the risk that arm's length assertions about related party transactions may be materially misstated. This may particularly apply in jurisdictions where the applicable financial reporting framework requires the disclosure of related party transactions if these were not conducted on terms similar to arm's length terms. In such circumstances, it may be effective for the auditor to rely on the controls over the process that management has implemented to determine which related party transactions have been conducted on arm's length terms and need therefore not be disclosed.

#### *Arm's Length Assertions* (Ref: Para. 19-20)

A33. Management is responsible for substantiating an arm's length assertion. Management's support for the assertion may include:

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

A34. Evaluating management's support for the arm's length assertion may involve one or more of the following:

- Considering the appropriateness of management's process for supporting the assertion.
- Verifying the source of the internal or external data supporting the assertion, and testing the data to determine their accuracy, completeness and relevance.
- When the substantiation rests on significant assumptions, evaluating whether these appear reasonable.

A35. A refusal by management to correct a material misstatement regarding an arm's length assertion may have implications on the audit, such as the reliance on representations made by management, the assessment of fraud risks, consideration of the need to modify the audit opinion, and consideration of whether to withdraw from the engagement. The auditor may also find it appropriate to consult legal counsel.

#### *Significant Non-Routine Related Party Transactions* (Ref: Para. 21)

A36. Appropriate authorization and approval by management, those charged with governance, or, where applicable, the entity's shareholders, of significant non-routine related party transactions may provide evidence that these have been duly considered at the appropriate levels within the entity and that their terms and conditions have been appropriately reflected in the financial statements. The existence of transactions of this nature that were not subject to such authorization and approval, in the absence of rational explanations based on discussion with management and those charged with governance, may indicate risks of material misstatement due to error or fraud. Authorization and approval alone, however, may not be sufficient in

## IAASB CAG REFERENCE PAPER

### IAASB CAG Agenda (September 2006)

#### Agenda Item N.1

#### Related Parties—Revised Post-ED Draft - September 2006 IAASB Agenda Item 7-B

concluding whether fraud risks are absent because authorization and approval may be ineffective if there has been collusion between the related parties or if the entity is subject to the dominant influence of another party.

#### Considerations Specific to Smaller Entities

A37. A smaller entity may not have the same compensating controls provided by different levels of authority and approval that may exist in a larger entity. Accordingly, when auditing a smaller entity, the auditor may rely to a lesser degree on authorization and approval for evidence regarding significant non-routine related party transactions.

#### *Identification of Previously Unidentified or Undisclosed Related Parties or Significant Related Party Transactions (Ref: Para. 22)*

A38. If management appears to have intentionally failed to identify or disclose related party relationships or significant related party transactions, this may indicate a significant risk of fraud. The requirements and guidance in ISA 240 regarding the auditor's responsibilities relating to fraud in an audit of financial statements are relevant in these circumstances. The auditor may also consider whether it is necessary to re-evaluate the reliance placed on management's responses to the auditor's inquiries and representations given to the auditor.

#### **Evaluation of Related Party Relationships, Transactions and Disclosures (Ref: Para. 23)**

##### *Materiality Considerations in Evaluating Misstatements*

A39. A consideration of both the quantitative and qualitative aspects of a related party transaction is important in evaluating whether a misstatement to which it gives rise is material, because:

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

##### *Evaluation of Related Party Disclosures*

A40. Evaluating the entity's related party disclosures means considering whether the facts and circumstances of the entity's related party relationships and transactions have been appropriately summarized and presented so that the disclosures are understandable. Disclosures of related party transactions may not be understandable if:

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

## **IAASB CAG REFERENCE PAPER**

### **IAASB CAG Agenda (September 2006)**

#### **Agenda Item N.1**

#### **Related Parties—Revised Post-ED Draft – September 2006 IAASB Agenda Item 7-B**

##### **Written Representations** (Ref: Para. 24)

- A41. Obtaining written representations enables the auditor to receive confirmation from management and, where appropriate, those charged with governance that they have disclosed to the auditor all relevant information relating to identified related parties, and that they are not aware of any other related party matters required by the applicable financial reporting framework to be disclosed in the financial statements. Such representations effectively provide a way to emphasize to management and, where appropriate, those charged with governance their responsibility to disclose the identity of related parties to the auditor even if there have been no transactions with such parties. The representations may also address, where appropriate, specific related party issues, such as the existence of undisclosed side agreements on significant related party transactions.
- A42. The requirement to obtain written representation regarding the completeness and accuracy of related party information applies even if there have been no related party transactions during the reporting period. Management may consider it appropriate to refer, within the written representation, to a complete listing of related party information that it may have provided to the auditor during the audit. If the auditor has not identified transactions with related parties during the audit, the auditor may request from management and, where appropriate, those charged with governance a written representation to that effect.
- A43. The purpose of emphasizing the economic substance of related party relationships and transactions as part of the written representations is to enable management and, where appropriate, those charged with governance to give particular consideration to whether the related party transactions and the effects of the related party relationships have been appropriately accounted for based on the substance of the relationships and transactions, and not merely their legal form.
- A44. Circumstances in which it may be appropriate to obtain written representations from those charged with governance include:
- When they have approved specific related party transactions that (a) materially affect the financial statements, or (b) involve management.
  - When they have made specific oral representations to the auditor on details of certain related party transactions.
  - When they have financial or other interests in the related parties or the related party transactions.
  - When they are responsible for the financial statements.

##### **Communication with Those Charged with Governance** (Ref: Para. 25)

- A45. Communication of significant related party issues identified during the audit with those charged with governance helps the auditor to establish a common understanding with them of the nature and resolution of these issues. This may also provide an opportunity for the auditor

## **IAASB CAG REFERENCE PAPER**

### **IAASB CAG Agenda (September 2006)**

#### **Agenda Item N.1**

#### **Related Parties—Revised Post-ED Draft - September 2006 IAASB Agenda Item 7-B**

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