

*Proposed Revised and Redrafted International  
Standard on Auditing*

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ISA 550, Related Parties



International Federation  
of Accountants

## REQUEST FOR COMMENTS

The International Auditing and Assurance Standards Board (IAASB), an independent standard-setting body within the International Federation of Accountants (IFAC), approved the exposure draft, proposed International Standard on Auditing (ISA) 550 (Revised and Redrafted), “Related Parties,” for publication in February 2007. The proposed ISA may be modified in light of comments received before being issued in final form.

Please submit your comments, preferably by email, so that they will be received by **June 30, 2007**. All comments will be considered a matter of public record. Comments should be addressed to:

International Auditing and Assurance Standards Board  
International Federation of Accountants  
545 Fifth Avenue, 14<sup>th</sup> Floor  
New York, New York 10017 USA

Comments should be emailed to [Edcomments@ifac.org](mailto:Edcomments@ifac.org). They may also be faxed to +1-212-286-9570 or mailed to the above address.

Copies of the exposure drafts may be downloaded free-of-charge from the IFAC website at <http://www.ifac.org>.

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# **EXPLANATORY MEMORANDUM AND BASIS FOR CONCLUSIONS FROM RESPONSES TO FIRST EXPOSURE DRAFT**

## **Introduction**

1. This memorandum provides background to, and an explanation of, the proposed International Standard on Auditing (ISA) 550 (Revised and Redrafted), “Related Parties,” approved for re-exposure by the International Auditing and Assurance Standards Board (IAASB) in February 2007. The memorandum incorporates the bases for conclusions in respect of significant comments the IAASB received on the first exposure draft of ISA 550 (Revised and Redrafted).

## **Background**

2. 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 fraud, because of the nature of related party relationships.
3. 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 recent past 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 where the applicable financial reporting framework establishes no requirements for the accounting for and disclosure of related party relationships and transactions (or does so inadequately), it is necessary for the auditor to be aware of related parties and the extent to which they affect the financial statements.
  - Following the issue of the audit risk standards, there was a need to revise the existing 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 performing appropriate procedures to respond to such risks.
4. In December 2005, the IAASB published proposed ISA 550 (Revised and Redrafted), “Related Parties” (“Exposure Draft”). The comment period closed on April 30, 2006. The following summarizes the more significant issues respondents raised, and how the IAASB has addressed them. The IAASB concluded that re-exposure of the proposed ISA is necessary because the changes made to the Exposure Draft as a result of responding to the comments received on exposure are significant and substantive.

## **Significant Issues and Related Proposals**

### **Interaction with the Audit Risk and Fraud ISAs**

5. The Exposure Draft adopted an approach to the audit of related party relationships and transactions consistent with the audit risk model. Nevertheless, several respondents noted that the interaction of the proposed ISA with the audit risk and fraud ISAs was not particularly

clear in the Exposure Draft. Some of them perceived a lack of context for the proposed risk assessment procedures, which caused these procedures to appear to be an isolated and complete set of procedures relating exclusively to related parties, although many of the procedures derive from requirements in other ISAs. They also noted that a number of the proposed requirements relating to the identification of related party relationships and transactions appeared to be improperly characterized as risk assessment procedures. Others asked why, after requiring the auditor to perform risk assessment procedures, the Exposure Draft did not also require the auditor to determine whether there were any actual risks of material misstatement associated with related parties, and whether such risks were significant risks. Some felt that the emphasis on arm's length assertions alone as a significant risk, without a more general assessment of the significance of other identified risks, was inappropriate.

6. Some respondents also argued that the Exposure Draft gave the impression that *all* related party transactions represent significant risks. They noted that the vast majority of related party transactions are routine, occurring mostly within groups of entities, and do not represent significant risks. Accordingly, they suggested that the proposed ISA should be more balanced in its description of such transactions.
7. Two respondents were of the view that the proposed ISA should distinguish between risks at the financial statement level and risks at the assertion level. They noted that the Exposure Draft focused mainly on responses to risks at the assertion level, without due regard to overall responses to risk at the financial statement level. They argued that because of the inherent limitations associated with the audit of related party relationships and transactions, the resulting risk of misstatement at the financial statement level should be a significant risk. Accordingly, they suggested that the proposed ISA should provide overall responses to such risk, for example, an emphasis on maintaining professional skepticism, and a greater consideration of the control environment.
8. In developing the Exposure Draft, the IAASB did not intend that related party relationships and transactions should be audited in a vacuum. Rather, the IAASB's aim was to develop the proposed ISA within the context of the audit risk and fraud ISAs, without duplicating the requirements and guidance in these ISAs. The IAASB, however, accepted respondents' comments that the proposed ISA should provide a better explanation of its inter-relationship with the audit risk and fraud ISAs. The IAASB has revised the wording of the Exposure Draft accordingly (e.g., see paragraphs 1, 12-13, 20-22 and A6).
9. In addition, the IAASB agreed that some of the requirements in the Exposure Draft created ambiguity regarding whether they were in the nature of risk assessment procedures or responses to assessed risks. The IAASB believes that the revised requirements provide a better demarcation between these two categories of procedures. In particular, dominant parties are now considered in the identification of, and response to, risks of material misstatement due to fraud (see paragraphs 20, A20-A21 and paragraphs 22 and A25), as opposed to being the subject of a specific risk assessment procedure (see further discussion of dominant parties below). Further, the requirement to obtain evidence that significant related party transactions outside the normal course of business have been authorized and approved is now treated as a response to significant risk (see paragraph 24(b)) as opposed to

a risk assessment procedure because it is more in the nature of a procedure performed to respond to an identified risk.

10. The IAASB also concluded that the proposed ISA would be better balanced if it specifically recognized that in many cases, related party transactions are conducted in the normal course of business and may carry no higher risk of material misstatement than similar transactions with unrelated parties (see paragraph 2).
11. But the IAASB did not agree that there is a need to specify overall responses to risk at the financial statement level for related parties in this ISA. The risk arising from related parties at the financial statement level is an integral part of a broader fraud risk at the financial statement level. Accordingly, the IAASB believes it is unnecessary to duplicate the requirement in ISA 240 (Redrafted), “The Auditor’s Responsibilities Relating to Fraud in an Audit of Financial Statements” for the auditor to determine overall responses to risks at the financial statement level. The IAASB, however, accepted in part the suggestions from the respondents that there should be a greater emphasis on the need for the auditor to maintain professional skepticism (see paragraph 8) and to be alert for information that may indicate the existence of related party relationships and transactions (see paragraph 19).

### **Inherent Limitation in Identifying Related Party Relationships and Transactions**

12. The Exposure Draft explained that, for a number of reasons, there is an inherent limitation regarding the auditor’s ability to identify all related party relationships and transactions. There were a number of opposing views from respondents regarding whether such explanatory material is essential for the proposed ISA. Some respondents were of the view that highlighting the inherent limitation of the auditor’s ability to identify related party relationships and transactions detracted from the need to strengthen the auditor’s performance in this area, and unnecessarily reiterated the limitations implicit in an audit. These respondents suggested that such discussion be centralized in ISA 200, “Objective and General Principles Governing an Audit of Financial Statements” and that the emphasis in the proposed ISA be changed to highlight the need for the auditor to be even more alert in this area. Other respondents took an opposing view, arguing that the Exposure Draft gave the impression that many more undisclosed related party transactions could be expected to be brought to light. The latter generally suggested the need for additional clarity regarding the fact that even a well-conducted audit performed in accordance with ISAs may not necessarily lead to the detection of undisclosed related party transactions, especially if those transactions are intentionally concealed from the auditor.
13. The IAASB concluded that in the case of related parties, because of the risks associated with the special nature of related party relationships, it is important to highlight the inherent limitation in the auditor’s ability to identify related party relationships and transactions. The IAASB agreed to clarify the related explanatory material in the introduction to achieve a more balanced message (see paragraphs 7-8).

## Objective of the ISA

14. Regarding the proposed objective in the Exposure Draft, many respondents expressed concern that it seemed to represent a summary of requirements or procedures set out elsewhere in the Exposure Draft, and that it seemed unduly focused on process. Several of the respondents supported an outcome-based objective. Two of them emphasized that the auditor should only be required to “pursue” the objective rather than achieve the outcome of the objective, given the inherent limitations regarding related parties.
15. Some of the respondents were concerned that some of the requirements supporting the proposed objective were rather open-ended or impractical. For example, they disagreed with the inclusion among the risk assessment procedures of a proposed requirement for the auditor to perform procedures intended to identify the parties to which a dominant party is related, and to understand the nature of the business relationships that these parties may have established with the entity.
16. A number of respondents suggested that the objective should specifically include the identification of related party relationships and transactions because such identification would provide a starting point for obtaining the information necessary to assess and respond to the risks associated with those relationships and transactions. One respondent felt that the audit of related parties should not be an end in itself and that the objective should reflect the application of the audit risk ISAs in the context of identifying and appropriately responding to the risks resulting from related parties. Another respondent noted that the identification of related parties and the audit of related party transactions should be responsive not only to the objective of the proposed ISA but also to those of other ISAs such as ISA 240 (Redrafted). The latter argued that because other standards would contribute to the achievement of the objective of the proposed standard, it would not be possible to evaluate the achievement of the proposed objective in isolation.
17. The IAASB concluded that the objective should clearly reflect the three distinct responsibilities the auditor has in respect of related parties, i.e.:
  - (a) To obtain sufficient appropriate audit evidence about whether related party relationships and transactions have been appropriately accounted for and disclosed in accordance with the applicable financial reporting framework; and
  - (b) Irrespective of whether the applicable financial reporting framework establishes related party requirements:
    - (i) To obtain an understanding of related party relationships and transactions sufficient to be able to conclude whether the financial statements, insofar as they are affected by those relationships and transactions:
      - 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. (See paragraph 10).

18. The first part of the objective directs the auditor to obtain sufficient appropriate audit evidence about whether the entity has appropriately dealt with related party relationships and transactions in accordance with the relevant accounting and disclosure requirements of the framework, whatever these may be. The second and third parts apply regardless of the requirements of the framework. The second part emphasizes the importance of obtaining an understanding of related party relationships and transactions, recognizing that these may affect whether the financial statements achieve fair presentation (for fair presentation frameworks) or are not misleading (for compliance frameworks) (see paragraphs A1-A2). The third part directs the auditor to identify fraud risk factors to which related party relationships and transactions specifically give rise in the overall identification and assessment of fraud risks.
19. The IAASB believes that this three-part approach to the auditor's responsibilities represents a more clearly focused objective that is more outcome-based as compared with the approach taken in the Exposure Draft. The IAASB is of the view that the revised objective, and the corresponding revised requirements, respond appropriately to the concerns that many respondents expressed regarding the open-ended nature of the requirements proposed in the Exposure Draft.
20. Regarding whether the auditor should only be required to pursue the objective rather than achieve the outcome, the IAASB has already dealt with the point more generally in revising the "Preface to the International Standards on Quality Control, Auditing, Review, Other Assurance and Related Services" (the Preface). Regarding the suggestion that the objective should specifically include the identification of related party relationships and transactions, the IAASB is of the view that this is a prerequisite to meeting the revised objectives and does not in itself represent a final outcome.
21. With regard to the suggestion that the objective should reflect the application of the audit risk standards, the IAASB did not believe that this would reflect the three specific parts to the auditor's responsibilities in respect of related parties as clearly as the proposed revised objectives. Finally, in relation to the comment that the audit of related party transactions should be responsive to the objectives of other ISAs, the IAASB notes that the Preface already emphasizes that the auditor aims to achieve the objectives of each ISA having regard to the inter-relationships amongst the ISAs, i.e., the Preface recognizes that the audit of an individual element, account or item in the financial statements cannot be undertaken in a vacuum but needs to take into account the interrelationships amongst the relevant ISAs. Accordingly, the IAASB agreed that it is unnecessary to re-emphasize this point in the objectives in this ISA. (As discussed above, the point is reinforced in the requirements.)

### **Related Party Definitions**

22. The Exposure Draft proposed that the auditor use the related party definitions in the applicable financial reporting framework if provided, and defaulted to the definitions in International Accounting Standard (IAS) 24, "Related Party Disclosures," if the framework did not contain any related party definitions and requirements.
23. Some respondents noted that the IAS 24 definitions would only apply for frameworks that do not establish related party requirements, and not for frameworks that establish only limited

such requirements. They argued that this would result in the proposed ISA mandating the use of more extensive related party definitions in some jurisdictions than in others. They felt that without minimum definitions for audit purposes that would apply in all circumstances, auditors would apply the ISA inconsistently, with some interpreting the requirements broadly and others narrowly, depending on the definitions in the framework. Certain respondents also noted that the requirement to obtain written representations would be difficult to implement satisfactorily in the absence of related party requirements in the framework, because management would be unable to provide the necessary representations if the framework did not define the meaning of a related party.

24. Other respondents pointed out practical difficulties or limitations to the proposal, including:
  - The Exposure Draft seemed to be used to compensate for perceived inadequacies in financial reporting frameworks, with the proposed definitions potentially indirectly establishing requirements for management and those charged with governance.
  - The Exposure Draft appeared to involve the consideration of IAS 24 in isolation, even though IAS 24 refers to other International Financial Reporting Standards (IFRSs). The proposal thus seemed to depart from the aim for ISAs to be framework-neutral.
  - Defaulting to the IAS 24 definitions would set an impracticable benchmark in some circumstances, particularly in jurisdictions where government and state-owned enterprises play a significant role in the operations of many entities.
  - In jurisdictions where the definitions in the framework are less comprehensive than those in IAS 24, management may not have established the information systems necessary to identify related party relationships and transactions consistent with IAS 24.
25. Two respondents suggested that instead of establishing a rigid set of definitions for those circumstances where the applicable financial reporting framework contains no related party requirements, the proposed ISA should provide guidelines regarding the meaning of a related party to which the auditor could refer when applying the requirements of the ISA.
26. The IAASB concluded that, as a minimum, a principles-based definition of a related party should apply for the purposes of the ISA regardless of the applicable financial reporting framework, based on the concepts of control and significant influence. This proposed definition states that a related party is a party that:
  - (a) Controls or significantly influences, directly or indirectly through one or more intermediaries, the entity;
  - (b) The entity controls or significantly influences, directly or indirectly through one or more intermediaries; or
  - (c) Is under common control with the entity (such as through having common management or a common controlling shareholder).
27. The definition sets a minimum baseline for the auditor to determine whether parties should be treated as being related to the entity, and to which the framework may add but from which it may not subtract (see paragraph 11(c)). The IAASB believes that the baseline definition

will help to ensure a consistent approach to the audit of related party relationships and transactions regardless of how the framework defines a related party. In particular, this approach has the benefit of ensuring a minimum standard of work effort on the auditor's part in understanding related party relationships and transactions (and their effects on the financial statements) where the applicable financial reporting framework inadequately deals with related parties. In addition, the IAASB agreed that by setting a principles-based definition, it would help maintain the framework neutrality of the ISA.

28. To support this proposed definition, the IAASB has provided general guidance regarding relationships that may indicate the existence of control or significant influence (see paragraph A4). In addition, the IAASB has added guidance to further clarify that the related party definition in the framework may be broader than that proposed, and may include, in addition to parties that are actually controlling or significantly influencing the entity, parties that have the *ability* to exert control or significant influence over the entity (see paragraph A5). (See related Question 1 below.)
29. Finally, the IAASB agreed that it would be appropriate to limit the proposed requirement for the auditor to obtain general written representations to those circumstances where the framework establishes related party requirements. In circumstances where the framework has no such requirements, the IAASB acknowledged that such a representation would not be directly relevant to the financial statements as presented in accordance with the framework (see paragraph 27).

#### *Inquiries Regarding Related Party Relationships and Transactions*

30. In line with the revised approach to the related party definition, the IAASB agreed to revise the requirement for the auditor to make inquiries of management regarding the entity's related party relationships and transactions as follows:
  - Where the applicable financial reporting framework establishes related party requirements, to obtain the names of the related parties management has identified in accordance with the framework, and to understand the nature of the related party relationships and transactions (see paragraph 14).
  - Where the framework establishes minimal or no related party requirements, to (a) identify the parties that control or significantly influence the entity, that the entity controls or significantly influences, or that are under common control with the entity, and (b) understand the nature of any business the entity has undertaken with such parties (see paragraph 15).
31. The first case is, in effect, a completeness test because the framework will have established related party definitions and requirements with which management has to comply. The second case applies where the framework contains no related party requirements (or does so inadequately). In such a case, the inquiries the auditor is required to make of management will assist the auditor in identifying those parties that the IAASB believes should, at a minimum, be treated as being related to the entity. If the framework has a less comprehensive related party definition than this ISA, this second requirement will ensure that the auditor will

go beyond the narrow framework requirements to capture a broader set of relevant parties consistent with the baseline definition.

### **Significant Non-routine Transactions**

32. The Exposure Draft focused on the identification of previously unidentified or undisclosed related party relationships and transactions through the performance of procedures directed towards significant non-routine transactions. A number of respondents felt that there would be practical difficulties in inquiring of management regarding such types of transactions because, in the absence of an agreed definition, management would have its own interpretation of the words “significant” and “non-routine.” Some respondents also argued that the requirement seemed to cast a very wide net in the search for unidentified or undisclosed related party relationships and transactions, which may not be cost-effective. Further, they thought that the focus on significant non-routine transactions seemed to ignore unidentified or undisclosed *routine* related party transactions.
33. The IAASB acknowledged these practical concerns. Accordingly, it agreed to replace such a search with a requirement that if, during the audit, the auditor identifies significant transactions outside the normal course of business, the auditor shall make appropriate inquiries of management to understand the nature of the transactions and whether they involve related parties (see paragraph 18). The proposed revised requirement complements the related requirement set out in ISA 240 (Redrafted) for the auditor to evaluate, for significant transactions outside the normal course of business, whether the business rationale of the transactions suggests that they may have been entered into for fraudulent reasons.
34. The IAASB also agreed that the auditor should obtain an understanding of the controls that management has established to authorize and approve significant transactions and arrangements with related parties and those that are outside the normal course of business (see paragraph 16(b)-(c)). The IAASB believes that by performing appropriate procedures to understand the entity’s controls in these areas, the auditor will be better placed to identify such transactions and arrangements for further investigation.

### ***Mandatory Review of Records or Documents***

35. The Exposure Draft contained a specific requirement for the auditor to review appropriate records or documents for transactions that are both significant and non-routine that may indicate the existence of previously unidentified or undisclosed related party relationships and transactions. It also proposed that this review should include a review of bank and legal confirmations, minutes of meetings of shareholders and of those charged with governance, and other relevant statutory records.
36. Several respondents disagreed with this proposal. Some noted that requiring specific records or documents to be reviewed could imply that the auditor would not need to have the same concerns regarding related parties when reviewing other records or documents. Some respondents also observed that many of the other types of records or documents listed in the application material of the Exposure Draft could be more helpful in identifying related party relationships and transactions than the documents listed in the requirements section. Some argued that there would be a consistency issue as bank confirmations are not standardized

throughout the world. They also noted that the term “statutory records” was ambiguous, as they believed it could be misinterpreted as meaning the entity’s accounting records.

37. Certain respondents suggested a more principles-based approach to require the auditor to inspect those records or documents that, in the particular circumstances of the engagement, could indicate the existence of unidentified or undisclosed related parties relationships and transactions. This would encourage the auditor to consider other means of obtaining relevant information.
38. The IAASB acknowledged the force of these concerns. However, the IAASB generally does not agree that a requirement for the auditor to inspect records or documents that, *in the circumstances*, could indicate the existence of unidentified or undisclosed related party relationships and transactions would be appropriate because this would be too open-ended. It also noted that there were other respondents who supported the list of records that should be reviewed and proposed that some of the examples included in the application material should be added to the list of records required to be reviewed. The IAASB therefore decided to retain a revised list of records and documents that the auditor is to review, combined with a general requirement for the auditor to be alert for significant transactions outside the normal course of business, as well as arrangements or other information that may indicate the existence of unidentified or undisclosed related party relationships or transactions (see paragraphs 18-19). The IAASB believes that this will reinforce the need for the auditor to be looking for unidentified or undisclosed related party relationships and transactions when performing all other audit procedures. The IAASB has provided supporting guidance on those types of transactions and arrangements that may indicate the existence of related party relationships and transactions (see paragraphs A17-A18).

#### *Significant Transactions Involving Management or Those Charged with Governance*

39. Guidance in the Exposure Draft stated that significant transactions involving management or those charged with governance, or third parties related to them, are non-routine because of the nature of the related party relationships. It also stated that transactions may be regarded as significant where they appear to be significant to the related parties even though not material to the entity. Some respondents questioned whether significant transactions involving management or those charged with governance should be treated as non-routine in this way by default. They argued that some of these transactions could well be conducted in the normal course of business. They also questioned the practicability of the auditor making a determination as to whether transactions are significant to the related parties even though not material to the entity. They argued that the auditor should focus on material items, and materiality should be determined in the context of the entity’s financial statements and not its related parties. The IAASB accepted these comments. Accordingly, this proposed guidance has been deleted.

#### **Dominant Parties**

40. The Exposure Draft contained a requirement that where a party appears to actively exert dominant influence over the entity, the auditor shall perform procedures intended to identify the parties to which the dominant party is related, and understand the nature of the business

relationships that these parties may have established with the entity. Whilst a number of respondents supported this proposal, several others disagreed.

41. Among those who disagreed, many felt that the proposal would not be consistently applied because the terms “dominant influence” and “dominant party” were undefined. They also commented that the Exposure Draft did not explain the circumstances in which the auditor would identify a dominant party or dominant influence. In addition, some of them felt that there was ambiguity regarding the reference to “parties” to which the dominant party is related. Others were of the view that the proposal would not be workable or cost-effective because it was too open-ended. They believed it would set unrealistic expectations to require the auditor to perform unspecified procedures to identify the parties to which a dominant party is related and to understand the nature of the business relationships. Some of them also thought that the related procedures suggested in the application material (such as inquiry of the dominant party) would be impracticable, as there may be concealment and the dominant party would have no obligation to provide information to the auditor. They also argued that the proposal would effectively shift the primary responsibility for identifying such parties from management to the auditor.
42. Some respondents also highlighted the lack of guidance on the application of this proposal in small- and medium-sized audits. Since owner-managers would likely be considered dominant parties, they believed that the proposal would be unduly burdensome for these audits.
43. A number of the respondents suggested that a more practicable approach might be to position the procedure as a response to assessed risk, as opposed to a risk assessment procedure. This is on the basis that it would be more appropriate for the auditor to assess risks arising from dominant parties and other parties related to them based on the auditor’s understanding of the entity and its internal control, and then to determine whether significant risks exist to which the auditor could then appropriately respond.
44. The IAASB accepted these comments and concluded that the proposed ISA should highlight that the existence of a dominant party is a risk factor on its own, and indicate that in the presence of other risk factors, this may give rise a risk of fraud (see paragraphs A20-A21). In addition, the IAASB proposes revised guidance on some of the possible procedures the auditor may perform to respond to such risk (see paragraph A25). Finally, to address concerns about the lack of guidance regarding the meaning of dominant influence, the IAASB has proposed a definition of the term (see paragraph 11(b)) and supporting guidance (see paragraph A20). Such a definition centers on individuals because the IAASB believes the exercise of dominant influence, insofar as fraud risks are concerned, ultimately comes down to individuals. The exclusion of corporate entities as dominant parties also avoids scoping in entities within groups (which would be appropriately audited as part of the audits of the relevant groups) and governmental bodies that hold ultimate control. The IAASB, however, did not agree that smaller entities should receive a special exemption from the dominant party considerations set out in the re-exposure draft as the same risks applicable to larger entities may also apply in the smaller entities.

## Arm's Length Assertions

45. The Exposure Draft proposed a definition of “arm's length transaction” to address assertions that management may make in the financial statements that the entity has entered into transactions with related parties equivalent or similar to arm's length or market transactions. The Exposure Draft required the auditor to obtain sufficient appropriate audit evidence about any arm's length assertion management makes in the financial statements.
46. One respondent commented that the proposed definition was flawed in that it described such a transaction as one 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. This respondent noted that arm's length transactions could only be undertaken if the parties were in fact unrelated, as related parties in theory cannot negotiate totally free of the influence of the relationship. Thus, it argued that an assertion about a related party transaction being undertaken on arm's-length terms should be limited to asserting *equivalency* to arm's length terms.
47. The IAASB accepted this comment on the ground that although the auditor may readily obtain evidence regarding how the price of a related party transaction compares to that of an arm's length or market transaction, there are ordinarily practical limitations in obtaining evidence that all other terms and conditions of the related party transaction are identical to arm's length terms or normal market conditions. Accordingly, the IAASB concluded that the definition of an arm's length transaction should be revised to indicate that it is one conducted between a willing buyer and a willing seller where they are in fact unrelated (see paragraph 11(a)). Additionally, the IAASB agreed to explain in the application material the rationale for treating as a significant risk an arm's length assertion that management has made in the financial statements (see paragraph A22).

## Effective Date

48. The IAASB will determine the effective date of the final ISA 550 (Revised and Redrafted) in due course, after considering the comments received on re-exposure. This date will, however, not be earlier than for audits of financial statements for periods beginning on or after December 15, 2008.

## Guide for Respondents

49. The IAASB has considered carefully the responses to its initial proposals. Although it is not seeking repetition of comments previously made, it welcomes comments on all matters addressed in the re-exposure draft, including the two matters set out in the request for specific comments below. Comments are most helpful when they refer to specific paragraphs, include the reasons for the comments, and, where appropriate, make specific suggestions for any proposed changes to wording. When a respondent agrees with proposals in this exposure draft (especially those calling for change in current practice), it will be helpful for the IAASB to be made aware of this view.

## Request for Specific Comments

### *Definition of a Related Party*

50. In developing the definition of a related party for the purposes of the ISA, the IAASB was guided by the principle that, in circumstances where the applicable financial reporting framework establishes no related party definitions and requirements, the first part of the definition (paragraph 11(c)(i)) should be sufficient to enable the auditor to identify those parties that are actively controlling or significantly influencing the entity (i.e. parties that are “pulling the strings”), and not all parties that have the *ability* to control or significantly influence the entity.
51. The IAASB recognized that although many financial reporting frameworks define a related party as one that has the *ability* to control or significantly influence the entity, broadening the ISA definition to include such a criterion would place an undue burden on the auditor and management to completely identify all the parties that would meet this definition. The IAASB acknowledged that where the framework does not define a related party, management will often not have designed and implemented an information system that would adequately identify related party relationships and transactions because of the absence of disclosure requirements in the framework. Accordingly, the first part of the proposed definition focuses only on those parties that *control or significantly influence* the entity. Consistent with this definition, where the framework has minimal or no related party requirements, the proposed ISA requires the auditor to make inquiries of management regarding the identity of those parties that control or significantly influence the entity (see paragraph 15(a)(i)).

**Question 1: Respondents are asked for their views on whether the proposed definition of a related party is appropriate.**

### *Implicit Arm’s Length Assertions*

52. The IAASB received comments from a number of respondents who noted a recent change to the European Union’s 4<sup>th</sup> and 7<sup>th</sup> Company Law Directives that would require disclosure of transactions *not* conducted under normal commercial or market conditions. The IAASB notes that in the absence of an explicit assertion by management to the contrary, there would be an *implicit* assertion that if related party transactions are not disclosed, they were conducted on normal commercial or market terms. These respondents suggested that the proposed ISA should deal with this situation.
53. The IAASB acknowledges that there will be significant cost and practical implications in auditing all related party transactions that have not been disclosed (especially for large audits) to obtain evidence that they were all conducted on terms equivalent or similar to arm’s length terms or normal market conditions. The IAASB did not reach a final conclusion on whether and how the proposed ISA should address the auditing implications of such a framework-specific requirement.

**Question 2: Respondents are asked for their views on whether the proposed ISA should address the auditing implications of implicit arm’s length assertions that management has made for related party transactions. If respondents support the provision of specific guidance,**

**respondents are asked for their views on an appropriate approach, bearing in mind that there would be a need to distinguish between explicit and implicit arm's length assertions.**

### **Comments on Other Matters**

54. Recognizing that the proposed ISA will apply to audits of all sizes and in all sectors of the economy, the IAASB is also interested in comments on matters set out below.

#### *Special Considerations in the Audit of Small Entities*

55. Respondents are asked to comment on whether, in their opinion, considerations in the audit of small entities have been dealt with appropriately in the proposed revised ISA. Reasons should be provided if not in agreement, as well as suggestions for alternative or additional guidance.

#### *Special Considerations in the Audit of Public Sector Entities*

56. A representative of the Financial Audit Guidelines Subcommittee of the International Organization of Supreme Audit Institutions participated in the development of the exposure draft. Respondents are asked to comment on whether, in their opinion, special considerations in the audit of public sector entities (paragraph A3) have been dealt with appropriately in the proposed revised ISA. Reasons should be provided if not in agreement, as well as suggestions for alternative or additional guidance.

#### *Developing Nations*

57. Recognizing that many developing nations have adopted or are in the process of adopting the ISAs, the IAASB invites respondents from these nations to comment, in particular, on any foreseeable difficulties in applying the proposed ISA in a developing nation environment. Reasons should be provided, as well as suggestions for alternative or additional guidance.

#### *Translations*

58. The IAASB welcomes comment from respondents on potential translation issues noted in reviewing the proposed revised ISA.

To be considered, responses should be emailed to [Edcomments@ifac.org](mailto:Edcomments@ifac.org). They may also be faxed to +1-212-286-9570 or mailed to 545 Fifth Avenue, 14th Floor, New York, NY 10017, USA.

# PROPOSED INTERNATIONAL STANDARD ON AUDITING 550

## (REVISED AND REDRAFTED)

### RELATED PARTIES

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

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\* See footnote 4.

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<p>International Standard on Auditing (ISA) 550 (Revised and Redrafted), “Related Parties” should be read in the context of the “Preface to the International Standards on Quality Control, Auditing, Review, Other Assurance and Related Services,” which sets out the authority of ISAs.</p>
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## Introduction

### Scope of this ISA

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

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

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

### *Responsibilities of the Auditor*

4. Because related parties are not entirely independent of each other, many financial reporting frameworks establish specific disclosure requirements for related party relationships, transactions and balances to enable users of the financial statements to understand their nature and actual or potential effects on the financial statements. Where the applicable financial reporting framework establishes such requirements, the auditor has a responsibility to perform procedures to identify, assess and respond to the risks of material misstatement arising from the entity's failure to appropriately account for or disclose related party relationships, transactions or balances in accordance with the requirements of the framework. (Ref: Para. A3)
5. Even if the applicable financial reporting framework establishes minimal or no related party requirements, the auditor nevertheless needs to obtain an understanding of the entity's related party relationships and transactions sufficient to be able to conclude whether the financial statements, insofar as they are affected by those relationships and transactions:
  - (a) Achieve fair presentation (for fair presentation frameworks); or (Ref: Para. A1)

- (b) Are not misleading (for compliance frameworks). (Ref: Para. A2)
6. In addition, an understanding of the entity's related party relationships and transactions is relevant to the auditor's identification of fraud risk factors in accordance with ISA 240 (Redrafted), because fraud may be more easily committed through related parties.
  7. As described in [proposed] ISA 200 (Revised and Redrafted), "Overall Objective of the Independent Auditor, and Fundamental Concepts Relevant to an Audit of Financial Statements,"<sup>1</sup> owing to the inherent limitations of an audit, there is an unavoidable risk that some material misstatements of the financial statements will not be detected, even though the audit is properly planned and performed in accordance with the ISAs. In the context of related parties, inherent limitations regarding the auditor's ability to detect material misstatements are greater for such reasons as the following:
    - Management may be unaware of the existence of all related party relationships and transactions.
    - Related party relationships may present a greater opportunity for collusion, concealment or manipulation by management.
  8. Maintaining an attitude of professional skepticism throughout the audit as required by [proposed] ISA 200 (Revised and Redrafted) is therefore particularly important in this context, given the potential for undisclosed related party relationships and transactions. The requirements in this ISA are designed to assist the auditor in identifying and assessing the risks of material misstatement associated with related party relationships and transactions, and in designing procedures to respond to such risks.

### Effective Date

9. This ISA is effective for audits of financial statements for periods beginning on or after [date].<sup>2</sup>

### Objectives

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

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<sup>1</sup> The IAASB has a project in progress to revise extant ISA 200, "Objective and General Principles Governing an Audit of Financial Statements." Where this Exposure Draft refers to proposed draft wording under consideration at present, the IAASB will consider the need for modification of the wording of this ISA as part of the deliberations relating to the future exposure and finalization of proposed revised and redrafted ISA 200.

<sup>2</sup> This date will not be earlier than December 15, 2008.

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.

## Definitions

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

- (a) Arm's length transaction – A transaction conducted on such terms and conditions as between a willing buyer and a willing seller who are unrelated and are acting independently of each other and pursuing their own best interests;
- (b) Dominant influence – Domination of the entity by a single individual or small group of individuals allowing them to impose their will on the significant decisions affecting the entity's business. Such an individual or group of individuals may form part of management or those charged with governance, or may have no official role within the entity; and
- (c) Related Party – A party that:
  - (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). (Ref: Para. A4)

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. (Ref: Para. A5)

## Requirements

### Risk Assessment Procedures and Related Activities

12. As part of the risk assessment procedures and related activities required by ISA 315 (Redrafted), the auditor performs the procedures and related activities set out in paragraphs 13 to 19 in order to obtain information relevant to identifying the risks of material misstatement associated with related party relationships and transactions. (Ref: Para. A6)

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

13. The discussion among members of the engagement team required by ISAs 315 (Redrafted) and 240 (Redrafted) shall include specific consideration of the susceptibility of the financial

statements to material misstatements due to fraud or error that could result from the entity's related party relationships and transactions. (Ref: Para. A7-A8)

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: (Ref: Para. A9)
    - (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.
16. Through inquiries of management and others within the entity, and by performing other procedures considered appropriate, the auditor shall obtain an understanding of the controls that management has established to: (Ref: Para. A10-A14, A16)
  - (a) Identify, account for, and disclose related party relationships and transactions in accordance with the applicable financial reporting framework;
  - (b) Authorize and approve significant transactions and arrangements with related parties; and
  - (c) Authorize and approve significant transactions and arrangements outside the normal course of business. (Ref: Para. A15)
17. The auditor shall share relevant information obtained about the entity's related parties with the other members of the engagement team.

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

18. If, during the audit, the auditor identifies significant transactions outside the normal course of business, the auditor shall inquire of management to understand the nature of these transactions and whether they involve related parties. (Ref: Para. A17)
19. During the audit, the auditor shall also be alert for arrangements or other information that may indicate the existence of related party relationships or transactions that management has not previously identified or disclosed to the auditor. In addition, the auditor shall inspect the

following documents for information that may indicate the existence of such relationships or transactions:

- (a) Bank and legal confirmations obtained as part of the auditor's procedures; and
- (b) Minutes of meetings of shareholders and of those charged with governance. (Ref: Para. A18-A19)

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

### **Identification and Assessment of the Risks of Material Misstatement Associated with Related Party Relationships and Transactions**

- 20. If, in carrying out the risk assessment procedures and related activities in relation to related parties, the auditor identifies fraud risk factors (including circumstances relating to the existence of a dominant party), the auditor shall consider such information when identifying and assessing the risks of material misstatement due to fraud in accordance with ISA 240 (Redrafted). (Ref: Para. A20-A21)
- 21. In identifying and assessing the risks of material misstatement as required by ISA 315 (Redrafted), the auditor shall treat at least the following as circumstances giving rise to significant risks:
  - Identified significant related party transactions outside the normal course of business.
  - Management has made an assertion in the financial statements stating that a related party transaction was conducted on terms equivalent or similar to those prevailing in an arm's length or market transaction. (Ref: Para. A22)

### **Responses to the Risks of Material Misstatement Associated with Related Party Relationships and Transactions**

- 22. As part of the responses to assessed risks required by ISA 330 (Redrafted), the auditor designs and performs further audit procedures that are responsive to the assessed risks of material misstatement associated with related party relationships and transactions. These procedures include those required by paragraphs 23-25. (Ref: Para. A23-A26)

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

- 23. If, when the applicable financial reporting framework establishes related party requirements, the auditor identifies related parties or significant related party transactions that management has not previously identified or disclosed to the auditor, the auditor shall:
  - (a) Promptly communicate any newly identified related parties to the other members of the engagement team to enable them to determine whether this information affects the results of, and conclusions drawn from, audit procedures already performed, including whether the risks of material misstatement need to be reassessed;

- (b) Request management to identify all transactions with the newly identified related parties for the auditor's further evaluation;
- (c) Inquire as to why the entity's controls over related party relationships and transactions failed to enable the identification or disclosure of the related party relationships or transactions;
- (d) Perform appropriate substantive procedures to respond to risks relating to such newly identified related parties or significant related party transactions; and (Ref: Para. A27)
- (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)<sup>3</sup>, and (ii) evaluate the implications on the audit. (Ref: Para. A28)

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

- 24. For identified significant related party transactions outside the normal course of business, the auditor shall:
  - (a) When evaluating the business rationale of the transactions as required by ISA 240 (Redrafted), evaluate whether their terms and the way they have been accounted for are consistent with management's explanations; and (Ref: Para. A29-A30)
  - (b) Obtain evidence that they have been authorized and approved. (Ref: Para. A31-A32)

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

- 25. When management has made an assertion in the financial statements stating that a related party transaction was conducted on terms equivalent or similar to those prevailing in an arm's length transaction or transaction under normal market conditions, the auditor shall obtain sufficient appropriate audit evidence about the assertion. If the auditor is unable to obtain sufficient appropriate audit evidence about the assertion, the auditor shall request management to delete or correct the assertion as appropriate. If management disagrees, the auditor shall consider the implications on the audit, including on the auditor's report. (Ref: Para. A33-A35)

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

- 26. In forming the opinion on the financial statements, the auditor shall evaluate:
  - (a) Whether the identified related party relationships and transactions have been appropriately accounted for and disclosed in accordance with the applicable financial

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<sup>3</sup> In accordance with [proposed] ISA 260 (Revised and Redrafted), "Communication with Those Charged with Governance," where all of those charged with governance are also involved in managing the entity, when matters are communicated with person(s) with management responsibilities, and those person(s) also have governance responsibilities, the matter need not be communicated again with those same person(s) in their governance role.

reporting framework; and

- (b) Whether the related party relationships and transactions could cause the financial statements to:
  - (i) Fail to achieve fair presentation (for fair presentation frameworks); or
  - (ii) Be misleading (for compliance frameworks). (Ref: Para. A36-A37)

### **Written Representations**

- 27. In addition to any specific written representations the auditor believes are necessary in relation to related parties, the auditor shall, where the applicable financial reporting framework establishes related party requirements, obtain written representations from management and, where appropriate, those charged with governance that:
  - (a) They have disclosed to the auditor the identity of the entity's related parties and all the related party relationships and transactions of which they are aware; and
  - (b) They have appropriately accounted for and disclosed such relationships and transactions in accordance with the requirements of the framework. (Ref: Para. A38)

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

- 28. Unless all of those charged with governance are involved in managing the entity and are aware of the matters already communicated by the auditor, the auditor shall communicate with those charged with governance significant matters identified during the audit regarding the entity's related party relationships and transactions. (Ref: Para. A39)

### **Documentation**

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

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## **Application and Other Explanatory Material**

### **Responsibilities of the Auditor** (Ref: Para. 4-5)

- A1. In the context of a fair presentation framework, related party relationships and transactions may cause the financial statements to fail to achieve fair presentation if, for example, the economic reality of such relationships and transactions is not appropriately reflected in the financial statements. For instance, fair presentation would not be achieved if the sale of a property by the entity to a controlling shareholder at a price above or below fair market value has been accounted for as a transaction involving a profit or loss for the entity when, in reality, it may constitute a contribution or return of capital or the payment of a dividend.
- A2. In the context of a compliance framework, related party relationships and transactions may cause the financial statements to be misleading in the particular circumstances of the

engagement. For example, the financial statements may be prepared for the benefit of a third party who is contemplating acquiring a significant equity stake in the entity at a price that is premised on the entity's ability to continue as a going concern. The financial statements may be misleading in these circumstances if the entity's status as a going concern depends largely on the financial support of one or more related parties, and that fact is not disclosed. As ISA 700, "The Independent Auditor's Report on General Purpose Financial Statements" indicates, however, cases in which financial statements prepared in accordance with a compliance framework are misleading in the circumstances are expected to be extremely rare.

### *Considerations Specific to Public Sector Entities*

- A3. The public sector auditor's responsibilities regarding related party relationships and transactions may be affected by the audit mandate, or by obligations on public sector entities arising from legislation, regulation, ministerial directives, government policy requirements, or resolutions of the legislature. Consequently, the public sector auditor's responsibilities may not be limited to addressing the risks of material misstatement associated with related party relationships and transactions, but may also include a broader responsibility to address the risks of non-compliance with laws and regulations governing public sector bodies that lay down specific requirements in the conduct of business with related parties. Further, the public sector auditor may need to have regard to public sector financial reporting requirements for related party relationships and transactions that may differ from those in the private sector.

### **Relationships that may Indicate Control or Significant Influence** (Ref: Para. 11(c))

- A4. The following relationships may indicate the existence of control or significant influence:
- (a) Direct or indirect equity or other financial interests in the entity (or vice versa).
  - (b) Being part of the management or those charged with governance of the entity.
  - (c) Being a close family member of any individual referred to in subparagraph (b).
  - (d) Having a business relationship with any individual referred to in subparagraph (b).
- A5. The related party definition in the applicable financial reporting framework may be broader than that set out in paragraph 11(c)(i)-(iii) and may include, in addition to parties that are actually controlling or significantly influencing the entity, parties that have the ability to exert control or significant influence over the entity.

### **Risk Assessment Procedures and Related Activities** (Ref: Para. 12)

- A6. Risk assessment procedures and related activities that the auditor performs in accordance with ISA 315 (Redrafted) provide information that is relevant to identifying the risks of material misstatement associated with related party relationships and transactions. For example, risk assessment procedures to obtain an understanding of:
- The entity's ownership and governance structures;
  - The types of investments that the entity is making and plans to make; and
  - The way the entity is structured and how it is financed

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

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

Discussion among the Engagement Team (Ref: Para. 13)

A7. Matters that may be addressed in the discussion among the engagement team include:

- The nature and extent of the entity's relationships and transactions with related parties.
- An emphasis on the importance of maintaining an attitude of professional skepticism throughout the audit regarding the potential for material misstatement associated with related party relationships and transactions.
- The circumstances or conditions of the entity that may indicate the existence of related party relationships or transactions that management has not identified or disclosed to the auditor (for example, a complex organizational structure or an inadequate information system).
- The importance that management and those charged with governance attach to the identification, appropriate accounting for, and disclosure of related party relationships and transactions (if the applicable financial reporting framework establishes related party requirements), and the related risk of management override of relevant controls.

A8. In addition, the discussion in the context of fraud may include specific consideration of how related parties may be involved in fraud. For example:

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

Inquiries and Other Risk Assessment Procedures (Ref: Para. 14 and 16)

A9. The auditor may also obtain some information regarding the identity of the entity's related parties through inquiries of management during the engagement acceptance or continuance process.

A10. Others within the entity are those considered likely to have knowledge of the entity's related party relationships and entity transactions. These may include, to the extent that they do not form part of management:

- Those charged with governance;

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

A11. As [proposed] ISA 200 (Revised and Redrafted) explains, the audit is conducted on the premises that management and, where appropriate, those charged with governance acknowledge and understand their responsibility for:

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

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

A12. In obtaining an understanding of the control environment in accordance with ISA 315 (Redrafted), the auditor may consider features of the control environment relevant in mitigating the risks of material misstatement associated with related party relationships and transactions, such as:

- Internal ethical codes, appropriately communicated to the entity's personnel and enforced, governing the circumstances in which the entity may enter into specific types of related party transactions.
- Policies and procedures for open and timely disclosure of the interests that management and those charged with governance have in related party transactions.
- The assignment of responsibilities within the entity for identifying, recording, summarizing, and disclosing related party transactions.
- Timely disclosure and discussion between management and those charged with governance of significant related party transactions outside the normal course of business, including whether those charged with governance have appropriately challenged the business rationale of such transactions (for example, by seeking advice from external professional advisors).

- Clear guidelines for the approval of related party transactions involving actual or perceived conflicts of interest, such as approval by a subcommittee of those charged with governance comprising individuals independent of management.
- Periodic reviews by internal audit, where applicable.
- Proactive action taken by management to resolve related party disclosure issues, such as by seeking advice from the auditor or external legal counsel.
- The existence of whistle-blowing policies and procedures, where applicable.

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, for example, the existence of transactions involving close family members of management.
- An insufficient understanding by management of the related party requirements of the applicable financial reporting framework.
- The absence of disclosure requirements under the applicable financial reporting framework.

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

A14. As discussed in ISA 240 (Redrafted), fraudulent financial reporting and misappropriation of assets often arise through management override of controls that otherwise appear to be operating effectively. The risk of management override of controls is higher if management has related party relationships with parties with which the entity does business because these relationships may present management with greater incentives and opportunities to perpetrate fraud. For example, management's financial interests in certain related parties may provide incentives for management to override controls by (a) directing the entity, against its interests, to conclude transactions benefiting the related parties, or (b) colluding with those parties or controlling their actions. Examples of possible fraud include:

- Creating fictitious terms of transactions with related parties designed to misrepresent the business rationale of these transactions.
- Fraudulently organizing the transfer of assets from or to management or others at amounts significantly above or below market value.
- Engaging in complex transactions with related parties, such as special-purpose

entities,<sup>4</sup> that are structured to misrepresent the financial position or financial performance of the entity.

A15. Examples of controls the entity may have established to authorize and approve significant transactions and arrangements outside the normal course of business include:

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

#### Considerations Specific to Smaller Entities

A16. As discussed in ISA 315 (Redrafted), the control environment in small entities is likely to be different from that in larger entities. In particular, those charged with governance in small entities may not include an independent or outside member, and the role of governance may be undertaken directly by the owner-manager where no other owners exist. Consistent with their simpler businesses, smaller entities may have fewer or no processes in place for dealing with related party relationships and transactions. Instead, the owner-manager in a small business may mitigate some of the risks that may arise from related party transactions through active involvement in all the main aspects of the transactions. Accordingly, for such entities, the auditor may only be able to obtain an understanding of the related party relationships and transactions through inquiry of management.

#### *Maintaining Alertness for Related Party Information When Performing the Audit* (Ref: Para. 18-19)

A17. Examples of transactions outside the normal course of business include:

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

A18. Examples of arrangements that may indicate the existence of related party relationships or transactions that management has not previously identified or disclosed to the auditor

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<sup>4</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.

include:

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

A19. The auditor may also inspect some or all of the following records or documents in the course of performing other audit procedures, which may provide new information about related party relationships and transactions:

- Third party confirmations (in addition to bank and legal confirmations).
- Entity income tax returns.
- Information supplied to regulatory authorities.
- Shareholder registers to identify the entity's principal shareholders.
- Statements of conflicts of interest from management and those charged with governance.
- Records of the entity's investments and those of its pension plans.
- Specific significant contracts and agreements not in the ordinary course of business, including those involving management and those charged with governance.
- Specific invoices and correspondence from professional advisors.
- Life insurance policies acquired by the entity.
- Significant contracts re-negotiated during the period.
- Internal audit working papers.
- Records or documents associated with the entity's filings with a securities regulator (for example, prospectuses).

**Identification and Assessment of the Risks of Material Misstatement Associated with Related Party Relationships and Transactions** (Ref: Para. 20-21)

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

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

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

entity.

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

- An unusually high turnover of senior management or professional advisors may suggest unethical or fraudulent business practices that serve the dominant party's purposes.
- The use of business intermediaries for significant transactions for which there appears to be no clear business justification may suggest that the dominant party could have an interest in such transactions through control of such intermediaries for fraudulent purposes.
- Evidence of the dominant party's excessive participation in or preoccupation with the selection of accounting policies or the determination of significant estimates may suggest the possibility of fraudulent financial reporting.

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

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

## **Responses to the Risks of Material Misstatement Associated with Related Party Relationships and Transactions** (Ref: Para. 22)

A23. The nature, timing and extent of the further procedures that the auditor may select to respond to the assessed risks of material misstatement associated with related party relationships and transactions depend upon the nature of those risks and the circumstances of the entity. ISA 330 (Redrafted) provides further guidance on considering the nature, timing and extent of further audit procedures. ISA 240 (Redrafted) establishes requirements and provides guidance on appropriate responses to assessed risks of fraud.

A24. Examples of substantive procedures that the auditor may perform when the auditor has assessed a significant risk that management has not appropriately accounted for or disclosed specific related party transactions in accordance with the applicable financial reporting framework (whether due to fraud or error) include:

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

regulation or ethical rules.

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

A25. If the auditor has assessed a significant risk of material misstatement due to fraud as a result of the presence of a party with dominant influence over the entity, the auditor may, in addition to the general requirements of ISA 240 (Redrafted), perform procedures such as the following to obtain an understanding of the business relationships that such a dominant party may have established directly or indirectly with the entity and to determine the need for further appropriate substantive procedures:

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

A26. In some circumstances, it may not be possible to obtain sufficient appropriate audit evidence from substantive procedures alone in relation to the risks of material misstatement associated with related party relationships and transactions. For example, where intra-group transactions between the entity and its components are numerous and a significant amount of information regarding these transactions is initiated, recorded, processed or reported electronically in an integrated system, the auditor may determine that it is not possible to design effective substantive procedures that by themselves would reduce the risks of material misstatement associated with these transactions to an acceptably low level. In such cases, as required by ISA 330 (Redrafted), the auditor tests the entity's controls over the completeness and accuracy of the recording of related party relationships and transactions in order to obtain sufficient appropriate audit evidence.

*Identification of Previously Unidentified or Undisclosed Related Parties or Significant Related Party Transactions* (Ref: Para. 23)

A27. Examples of substantive procedures that the auditor may perform to respond to risks relating to newly identified related parties or significant related party transactions include:

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

- Conducting an analysis of accounting records for transactions with the newly identified related parties. Such an analysis may be facilitated using computer-assisted audit techniques.
- Verifying the terms and conditions of the newly identified related party transactions, and evaluating whether the transactions have been accounted for in accordance with the applicable financial reporting framework.

A28. If management appears to have intentionally failed to disclose related parties or significant related party transactions to the auditor, this may indicate a fraud risk. The requirements and guidance in ISA 240 (Redrafted) regarding the auditor's responsibilities relating to fraud in an audit of financial statements are relevant in these circumstances. The auditor may also consider whether it is necessary to re-evaluate the reliability of management's responses to the auditor's inquiries and management's representations to the auditor.

*Identified Significant Related Party Transactions Outside the Normal Course of Business* (Ref: Para. 24)

A29. In evaluating the business rationale of a significant related party transaction outside the normal course of business, the auditor may consider the following:

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

A30. The auditor may also seek to understand the business rationale of such a transaction from the related party's perspective, as this may help the auditor to better understand the economic reality of the transaction and why it was carried out. A business rationale from the related party's perspective that appears inconsistent with the nature of its business may represent a risk factor.

A31. Authorization and approval by management, those charged with governance, or, where applicable, the entity's shareholders, of significant related party transactions outside the normal course of business may provide evidence that these have been duly considered at the appropriate levels within the entity and that their terms and conditions have been appropriately reflected in the financial statements. The existence of transactions of this nature that were not subject to such authorization and approval, in the absence of rational

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

#### Considerations Specific to Smaller Entities

- A32. A smaller entity may not have the same compensating controls provided by different levels of authority and approval that may exist in a larger entity. Accordingly, when auditing a smaller entity, the auditor may rely to a lesser degree on authorization and approval for evidence regarding significant related party transactions outside the normal course of business.

#### *Assertions that Related Party Transactions were Conducted on Terms Equivalent or Similar to Arm's Length Terms or Normal Market Conditions* (Ref: Para. 25)

- A33. Management is responsible for substantiating an assertion that a related party transaction was conducted on terms equivalent or similar to those of an arm's length transaction. Management's support for the assertion may include:

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

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

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

- A35. A refusal by management to correct a material misstatement regarding an assertion that a related party transaction was conducted on terms equivalent or similar to those of an arm's length transaction, either by amending the relevant disclosure or by providing additional appropriate disclosures, may have implications on the audit, such as the reliability of the representations made by management, the assessment of fraud risks, consideration of the need to modify the audit opinion, and consideration of whether to withdraw from the engagement. The auditor may also find it appropriate to consult legal counsel.

## **Evaluation of the Accounting for and Disclosure of Identified Related Party Relationships and Transactions** (Ref: Para. 26)

### *Materiality Considerations in Evaluating Misstatements*

A36. A consideration of both the size and nature of a related party transaction is important in evaluating whether a misstatement to which it gives rise is material, because:

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

### *Evaluation of Related Party Disclosures*

A37. Evaluating the entity's related party disclosures in the context of the disclosure requirements of the applicable financial reporting framework means considering whether the facts and circumstances of the entity's related party relationships and transactions have been appropriately summarized and presented so that the disclosures are understandable. Disclosures of related party transactions may not be understandable if:

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

## **Written Representations** (Ref: Para. 27)

A38. Specific written representations may address, where appropriate, specific related party issues, such as the existence of undisclosed side agreements on significant related party transactions. Circumstances in which it may be appropriate to obtain written representations from those charged with governance include:

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

## **Communication with Those Charged with Governance** (Ref: Para. 28)

A39. Communicating significant related party matters identified during the audit with those charged with governance helps the auditor to establish a common understanding with them of the nature and resolution of these matters. This may also provide an opportunity for the auditor to alert those charged with governance to significant related party relationships and

transactions of which they may not have been previously aware. Examples of significant related party matters include:

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



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