International Auditing and Assurance Standards Board

Exposure Draft
December 2005
Comments are requested by April 30, 2006

Proposed International Standard on Auditing 550 (Revised)

Related Parties

International Federation of Accountants

CONTENTS

REQUEST FOR COMMENTS

The International Auditing and Assurance Standards Board (IAASB) approved the enclosed exposure draft for publication in December 2005. The proposed International Standard on Auditing (ISA) may be modified in light of comments received before being issued in final form.

Please submit your comments, preferably by e-mail or on computer disk, so that they will be received by **April 30, 2006**. All comments will be considered a matter for the public record. Comments should be addressed to:

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International Auditing and Assurance Standards Board
545 Fifth Avenue, 14th Floor
New York, New York 10017 USA

Email responses should be sent to: Edcomments@ifac.org

This exposure draft is published in the English language. To achieve maximum exposure and feedback, the International Federation of Accountants encourages the reproduction of this publication in any format.

EXPLANATORY MEMORANDUM

Introduction

This memorandum provides background to, and an explanation of, the proposed International Standard on Auditing (ISA) 550 (Revised), “Related Parties,” approved for exposure by the International Auditing and Assurance Standards Board (IAASB) in December 2005.

Background

The audit of related party transactions is an essential part of an audit of financial statements. Although these transactions are a common feature of business, they may give rise to specific risks of material misstatement of the financial statements arising from inappropriate accounting, non-disclosure, or fraud.

The IAASB commenced this project in response to a number of developments that pointed to a need to revise the ISA. In particular, there has been greater public focus on the accounting and auditing of related party relationships and transactions given the impact of related parties in recent major corporate scandals. In addition, the extant ISA 550 is mainly procedural in nature and does not discuss the risks of material misstatements that may arise from the existence of related party relationships and transactions. Accordingly, the IAASB concluded that there was a need to review the ISA, and in doing so, to consider placing greater emphasis on the identification and assessment of these risks of material misstatements, and on the response to them.

The IAASB believes that the proposed revised ISA will enhance auditor performance in this particular area of the audit through more stringent requirements and expanded application guidance.

Significant Proposals

A Risk-Based Approach

The overall objective of the proposed revised ISA is for the auditor to obtain sufficient appropriate audit evidence about the accounting for, and disclosure of, related party relationships and transactions in the financial statements. This objective is achieved through:

(a) Obtaining an understanding of the entity’s related party relationships and transactions; and

(b) In the context of the applicable financial reporting framework:

  (i) Identifying and assessing the risks of material misstatements in the financial statements resulting from the related party relationships and transactions; and

  (ii) Responding to those assessed risks by designing and performing further audit procedures.

Using a risk-based approach to achieve the overall objective reflects the need to address the particular risks that are associated with related party relationships and transactions. These include the risks of material misstatements resulting from their non-identification or non-disclosure, and the higher risk of fraud due to the greater potential for collusion and for management override of controls.

The identification and assessment of, and the response to, these risks ordinarily occur within the context of the specific related party accounting and disclosure requirements of the applicable financial reporting framework. Where the applicable financial reporting framework does not establish these specific related party requirements, it is nevertheless necessary for the auditor to obtain an understanding of the nature and extent of related party relationships and transactions sufficient to evaluate whether their effects could result in the financial statements being misleading in the circumstances of the engagement (see paragraph 23 of the exposure draft).

Related Party Definitions

The exposure draft states that where the applicable financial reporting framework establishes related party requirements, the related party definitions set out in the framework apply for the purpose of the audit. This acknowledges that financial reporting frameworks may establish different related party definitions upon which the related party accounting and disclosure requirements are based. It is also consistent with the principle that ISAs should be framework-neutral.

In some cases, however, the applicable financial reporting framework may not establish any related party accounting or disclosure requirements, and may, therefore, not provide any related party definitions. For this type of situation, the exposure draft provides definitions (based on those in International Accounting Standard (IAS) 24, "Related Party Disclosures") which apply for the purpose of the ISA. These definitions enable the auditor to comply with the requirements of the ISA in such cases in terms of understanding the effects of related party relationships and transactions, but it is not intended thereby to impose accounting and disclosure requirements where none is included in the framework. The appendix to the exposure draft provides the relevant definitions.

Mandatory Risk Assessment Procedures to Identify Related Party Relationships and Transactions not Identified or Disclosed by Management

Material misstatements resulting from related party relationships and transactions often arise from management's failure (whether intentional or not) to identify these relationships and transactions, or to disclose them to the auditor. The exposure draft therefore requires the auditor to perform a minimum set of risk assessment procedures specifically directed towards the identification of related party relationships and transactions not identified or disclosed by management. Furthermore, the exposure draft adopts a focused approach by requiring the auditor to direct the procedures mainly at identifying transactions that are both significant and non-routine, as these carry a higher risk of involving previously unidentified or undisclosed related parties. Should the auditor identify such transactions, the exposure draft requires the auditor to consider whether the transactions, or their circumstances, indicate the possible involvement of previously unidentified or undisclosed related parties.

Accordingly, the proposed basic requirement is for the auditor to:

(1) Inquire of management and others within the entity about the existence of transactions that are both significant and non-routine; and

(2) Review appropriate records or documents for transactions that are both significant and non-routine, and for other information that may indicate the existence of previously unidentified or undisclosed related party relationships or transactions.

In relation to the requirement in (2) above, records or documents that the auditor would need to review in all cases include the following:

(i) Bank and legal confirmations obtained by the auditor; and

(ii) Minutes of meetings of shareholders and those charged with governance, and other relevant statutory records.

The exposure draft provides guidance on other types of records or documents that the auditor may judge it appropriate to review (see paragraph A8).

In addition to the basic requirement in (1) and (2) above, there is a further proposed requirement regarding circumstances where a party appears to actively exert dominant influence over the entity. This recognizes that in such circumstances, there is a higher risk of that party overriding management to cause the entity to enter into transactions in which that party is interested. Accordingly, the exposure draft requires the auditor to perform procedures intended to identify the parties to which the dominant party is related, and to understand the nature of the business relationships that these parties may have established with the entity. These procedures may identify related party relationships or transactions that were not previously identified or disclosed to the auditor. In proposing this requirement, the IAASB determined that it would be in the public interest for the auditor to be proactive in this type of situation, even though it is recognized that there may be limitations to the effectiveness of such procedures. The fact that performing the procedures might not lead to the identification of any new related party relationships or transactions does not seem a good reason for not making the attempt. Paragraph A6 provides guidance on the types of procedures that the auditor may perform in these circumstances.

Disclosures of Arm's Length Assertions

The exposure draft introduces a new requirement that, where disclosure of a related party transaction indicates or implies that the transaction was conducted at arm's length, the auditor shall obtain sufficient appropriate audit evidence about the assertion. It also proposes that the auditor request management to withdraw the assertion if the auditor is unable to obtain sufficient appropriate audit evidence about the assertion, and to consider the implications for the auditor's report if management disagrees.

These proposed requirements respond to the particular risk of material misstatement that may arise from the disclosure of an arm's length assertion. In particular, the exposure draft recognizes that a significant risk exists where management finds it difficult to substantiate the assertion.

Enhanced Guidance on Related Party Disclosures

The extant ISA 550 requires the auditor to evaluate whether the entity's related party disclosures in the financial statements are adequate. The exposure draft expands on this basic requirement by providing enhanced guidance on the evaluation of related party disclosures. In particular, it adds a new focus on auditing the disclosures for understandability, in terms of:

(a) Whether the business rationale and financial effects of the related party transactions are clear; and

(b) Whether the key terms, conditions, or other important elements of the transactions necessary for understanding them have been appropriately disclosed.

Effective Date

The IAASB will determine the effective date of the final ISA in due course, after considering the comments received on exposure.

Guide for Respondents

The IAASB welcomes comments on the proposed revised ISA 550. Apart from the request for specific comments set out below, the IAASB is seeking comments on all matters addressed in the exposure draft. 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.

The exposure draft has been drafted in accordance with the new drafting conventions proposed under the Clarity Project. These are under exposure (see "Improving the Clarity of IAASB Standards," issued in October 2005); to the extent that the earlier consultation leads to further changes in the approach to drafting ISAs, these will be reflected in the final ISA 550. For the purposes of commenting on this exposure draft, respondents are asked to consider whether the objective for the ISA is appropriate, and whether the proposed requirements are appropriate responses to that objective.

Request for Specific Comments

The IAASB would particularly welcome comments on the proposed requirement in paragraph 11(b) 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. Do you agree with this proposed requirement? If not, please explain why.

Comments on Other Matters

Recognizing that the proposed revised 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

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

A representative of a working group of the Financial Audit 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 have been dealt with appropriately in the exposure draft. Reasons should be provided if not in agreement, as well as suggestions for alternative or additional guidance.

Developing Nations

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 exposure draft in a developing nation environment. Reasons should be provided, as well as suggestions for alternative or additional guidance.

Translations

The IAASB welcomes comment from respondents on potential translation issues noted in reviewing this exposure draft.

PROPOSED INTERNATIONAL STANDARD ON AUDITING 550 (REVISED)

RELATED PARTIES

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

CONTENTS

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.

Related Parties in the Context of an Audit of Financial Statements

2. Although an entity may enter into related party transactions as part of its normal course of business, such transactions may not be conducted at arm's length. Accordingly, financial reporting frameworks ordinarily establish accounting and disclosure requirements for related party transactions to enable users of the financial statements to understand the nature and financial effects of these transactions. Financial reporting frameworks may also require related party relationships to be disclosed to enable users to understand the nature of the relationships and their potential effects on the financial statements. When the applicable financial reporting framework does not establish such requirements, this ISA is nevertheless relevant for the auditor in obtaining an understanding of the entity's related party relationships and transactions, and their significance to, and effects on, the financial statements.

3. The risk that the entity does not identify and appropriately account for or disclose related party relationships and transactions may be higher for a number of reasons, including the following:

   (a) Related parties may operate through an extensive and complex range of relationships and structures, and may enter into complex transactions;

   (b) Related party transactions may be informal; for example, in smaller entities, there may be relationships and transactions involving family members of management that are not fully documented or formally approved;

   (c) Information systems may not be designed to identify or summarize transactions and outstanding balances between an entity and its related parties; and

   (d) Related party transactions may not be conducted in the normal course of business; for example, some related party transactions may be conducted with no exchange of consideration.

   As a result, related party relationships may present more opportunity for collusion, concealment or manipulation, resulting in a higher risk of fraud, especially if the related parties are not disclosed to the auditor.

4. For these reasons, there is an inherent limitation regarding the auditor's ability to identify all related party relationships and transactions. Accordingly, there is an unavoidable risk that some material misstatements in the financial statements resulting from related party relationships or transactions may not be detected, even though the audit is properly planned and performed in accordance with ISAs.

Effective Date

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

Objective to be Achieved

6. In relation to this ISA, the objective of the auditor is to obtain sufficient appropriate audit evidence about the accounting for, and disclosure of, related party relationships and transactions in the financial statements, through:

   (a) Obtaining an understanding of these relationships and transactions; and

   (b) In the context of the applicable financial reporting framework:

      (i) Identifying and assessing the risks of material misstatements in the financial statements resulting from the related party relationships and transactions; and

      (ii) Responding to those assessed risks by designing and performing further audit procedures.

Definitions

7. Where the applicable financial reporting framework establishes related party requirements, the related party definitions set out in the framework apply for the purpose of the audit. Where the applicable financial reporting framework does not establish related party requirements, the definitions set out in the Appendix apply for the purpose of this ISA.

8. The following other terms are introduced in this ISA:

   (a) "Arm's length transaction" – a transaction conducted on such terms and conditions as between a willing buyer and a willing seller acting as if they were unrelated and pursuing their own best interests;

   (b) "Conflict of interest" – in relation to management or those charged with governance, a situation that arises from (i) being in a position to advance their own personal interests contrary to their fiduciary responsibilities to the entity, or (ii) having competing responsibilities to two or more entities; and

   (c) "Material misstatement resulting from related parties" – a material misstatement of the financial statements due to fraud or error arising from the failure to appropriately account for or disclose related party relationships, transactions or balances.

Requirements

Risk Assessment Procedures

Ascertaining the Identity of the Entity's Related Parties and the Nature of Its Related Party Relationships and Transactions

9. The auditor shall inquire of management at the beginning of the audit regarding the identity of the entity's related parties and the nature of its related party relationships and transactions. (Ref: Para. A1)

10. In inquiring about the entity's related party relationships, the auditor shall obtain an understanding of how the entity is controlled or significantly influenced,[1] and how it controls or significantly influences the related parties. (Ref: Para. A2)

11. Material misstatements resulting from related parties often arise from management's failure (whether intentional or not) to completely identify or disclose the entity's related party relationships and transactions. Accordingly, the auditor shall, in addition, perform the following risk assessment procedures specifically directed towards identifying related party relationships and transactions not identified or disclosed by management:

    (a) Inquire of management and others within the entity about the existence of transactions that are both significant and non-routine; (Ref: Para. A3-A5)

    (b) Where a party appears to actively exert dominant influence over the entity, 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; and (Ref: Para. A6)

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

        (i) Bank and legal confirmations obtained by the auditor; and

        (ii) Minutes of meetings of shareholders and those charged with governance, and other relevant statutory records. (Ref: Para. A3-A4, A7-A8)

12. If the auditor identifies transactions that are both significant and non-routine, the auditor shall consider whether the transactions or their circumstances indicate the possible involvement of previously unidentified or undisclosed related parties.

Sharing of Relevant Related Party Information Among the Engagement Team

13. The discussion among members of the engagement team required by [proposed] ISA 315 (Redrafted), "Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement," shall place particular emphasis on the susceptibility of the entity's financial statements to material misstatement resulting from related parties. (Ref: Para. A9)

14. The auditor shall communicate to the engagement team the identity of the entity's related parties and other relevant related party matters arising during audit planning.

Understanding the Business Rationale of the Entity's Related Party Relationships and Transactions, and the Entity's Controls Over Them

15. The auditor shall obtain an understanding of the business rationale of the entity's related party relationships and transactions to assess whether they give rise to risks of material misstatements in the financial statements. In addition, for those related party transactions that

[1] The Appendix provides examples of definitions of control and significant influence.

are both significant and non-routine, the auditor shall determine whether they have been appropriately authorized and approved. (Ref: Para. A10-A12)

16. The auditor shall obtain an understanding of:

    (a) The internal control, including the control environment, that management has established to mitigate the risks of material misstatements resulting from related parties; (Ref: Para. A13-A15)

    (b) How those charged with governance oversee management's processes for identifying, accounting for, and disclosing related party relationships and transactions; and (Ref: Para. A16)

    (c) The specific controls that those charged with governance have implemented to mitigate the risk of management override of controls where related parties exist over which management is known to have control or significant influence, or in which management is known to have financial or other interests. (Ref: Para. A17)

Substantive Procedures Responsive to the Risks of Material Misstatements Resulting from Related Parties

17. In responding to assessed risks as required by [proposed] ISA 330 (Redrafted), "The Auditor's Procedures in Response to Assessed Risks," the auditor shall design and perform further audit procedures that are responsive to the assessed risks of material misstatements resulting from related parties. (Ref: Para. A18-A21)

Response to a Significant Risk of Material Misstatement Regarding an Arm's Length Assertion

18. The entity's disclosures may assert that a related party transaction has been conducted at arm's length. Management may find it difficult to substantiate such an assertion. Where this is the case, a significant risk exists that the assertion may be misstated.

19. When disclosure of a related party transaction indicates or implies that the transaction was conducted at arm's length, the auditor shall obtain sufficient appropriate audit evidence about the assertion. (Ref: Para. A22-A23)

20. If the auditor is unable to obtain sufficient appropriate audit evidence about an arm's length assertion, the auditor shall request management to withdraw the assertion. If management disagrees, the auditor shall consider the implications for the auditor's report.

Consequences of Identifying Previously Unidentified or Undisclosed Related Party Relationships or Transactions

21. If the auditor identifies related party relationships or transactions not previously identified or disclosed by management, the auditor shall:

    (a) Promptly communicate this information to the rest of the engagement team to enable them to determine whether it affects the results of, and conclusions drawn from, audit procedures already performed;

    (b) Request management to identify transactions with the newly identified related parties for the auditor's further evaluation;

(c) Investigate why the entity's controls over related party relationships and transactions failed to enable the identification or disclosure of the related party relationships or transactions; and

(d) If the non-identification or non-disclosure appears intentional, (i) communicate this information to those charged with governance, and (ii) evaluate the implications for other aspects of the audit, including the reliance placed on other responses from management to the auditor's inquiries.

Written Representations

22. The auditor shall obtain written representations from management and, where appropriate, those charged with governance concerning:

(a) The completeness and accuracy of information provided to the auditor regarding related party relationships and transactions;

(b) The appropriateness of related party disclosures in the financial statements; and

(c) The appropriateness of the accounting for related party relationships and transactions, having particular regard to their business rationale. (Ref: Para. A24-A25)

Evaluation of Related Party Relationships, Transactions and Disclosures

23. The auditor shall evaluate:

(a) Whether the entity's related party transactions have been properly accounted for and disclosed in accordance with the applicable financial reporting framework;

(b) Whether any other required related party disclosures have been presented in accordance with the applicable financial reporting framework; and

(c) Irrespective of the applicable financial reporting framework, whether the effects of the related party relationships and transactions could result in the financial statements being misleading[2] in the circumstances of the engagement. (Ref: Para. A26-A29)

Communication with Those Charged with Governance

24. Unless all of those charged with governance are involved in managing the entity, the auditor shall, in order to establish a common understanding with them and to alert them to significant related party relationships and transactions of which they may not have been aware, communicate with them:

(a) The nature, extent, business rationale and disclosure of significant related party

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[2] Section 110 of the IFAC *Code of Ethics for Professional Accountants* (Revised June 2005) requires a professional accountant not to be associated with reports, returns, communications or other information where they believe that the information (a) contains a materially false or misleading statement, (b) contains statements or information furnished recklessly, or (c) omits or obscures information required to be included where such omission or obscurity would be misleading, unless the professional accountant provides a modified report in respect of the information. ISA 700, "The Independent Auditor's Report on a Complete Set of General Purpose Financial Statements," and [proposed] ISA 701, "The Independent Auditor's Report on Other Historical Financial Information," provide further guidance on the circumstances when financial information could be considered misleading.

relationships and transactions, including those involving actual or perceived conflicts of interest; and

(b) Significant issues identified during the audit regarding the entity's related party relationships and transactions.

Documentation

25. In addition to the documentation requirements of [proposed] ISA 315 (Redrafted) and [proposed] ISA 330 (Redrafted), and, where relevant, [proposed] ISA 240 (Redrafted), "The Auditor's Responsibility to Consider Fraud in an Audit of Financial Statements," the auditor shall document:

    (a) The identity of the entity's related parties and the nature of the related party relationships; and

    (b) The procedures performed to comply with the requirement in paragraph 11(b) and, where applicable, any identified parties related to the dominant party referred to in that paragraph.

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Application Material

Risk Assessment Procedures

Ascertaining the Identity of the Entity's Related Parties and the Nature of Its Related Party Relationships and Transactions (Ref: Para. 9-11)

A1. Inquiring of management at the beginning of the audit enables the auditor to gather a complete and up-to-date list of the entity's related parties, and information on the nature of the transactions the entity has entered into with these parties.

A2. Control or significant influence can ordinarily be recognized by considering a party's ownership interests in, or extent of voting power over, an entity. Some circumstances may make it difficult for the auditor to obtain a full understanding of the nature of the related party relationships, for example:

- A complex shareholding structure.
- The sharing of control over the related party with external parties.
- The location of shareholder or other relevant records in a foreign or offshore jurisdiction.
- Control or significant influence over management or those charged with governance by external parties.

These circumstances increase the risk that material misstatements resulting from related parties may not be detected.

A3. It is appropriate to direct risk assessment procedures to identify previously unidentified or undisclosed related party relationships and transactions primarily at identifying transactions that are both significant and non-routine, as these carry a higher risk of involving unidentified or undisclosed related parties.

A4. 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. Transactions may be regarded as significant where they appear to be significant to the related parties even though not material to the entity. Other transactions that are both significant and non-routine may include, for example:

- Significant equity transactions, such as corporate restructurings or acquisitions.
- Significant transactions at or near the end of the reporting period.
- Transactions whose substance may give rise to questions about their propriety.
- The leasing of premises or the rendering of management services by the entity to another party if no consideration is exchanged.
- Significant sales transactions with unusually large discounts or returns.
- Significant transactions with circular arrangements, for example, sales with a commitment to repurchase.

Inquiries of Management and Others Within the Entity (Ref: Para. 11(a))

A5. Others within the entity are those considered likely to have knowledge of the entity's related party relationships and transactions. These may include, to the extent that they do not form part of management:

(a) Those charged with governance;

(b) Personnel in a position to initiate, process, or record transactions that are both significant and non-routine, and those who supervise or monitor such personnel;

(c) Internal audit;

(d) In-house legal counsel; and

(e) The chief ethics officer or equivalent person.

Procedures to Identify Parties Related to a Party Actively Exerting Dominant Influence (Ref: Para. 11(b))

A6. Where a party appears to be actively exerting dominant influence over the entity, there is a higher risk of that party overriding management to cause the entity to enter into related party transactions in which the party is interested. Such transactions may occur directly with the dominant party or indirectly with a third party to which it is related. The auditor may obtain information about this third party, as well as transactions it may have entered into with the entity, through such procedures as:

- Inquiries of, and discussion with, management and those charged with governance.
- Inquiries of 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.
- Procedures performed during the client acceptance or continuance process.

Review of Specific Records or Documents (Ref: Para. 11(c))

A7. In reviewing the records or documents, the auditor may identify information that may indicate the existence of previously unidentified or undisclosed related party relationships or transactions. Such other information may include, for example:

- Guarantees and guarantor relationships.
- Loans or other advances outside the normal course of business, including those to management, to those charged with governance, or to parties related to either.

A8. The auditor may consider it appropriate to review other types of records or documents such as:

- Third party confirmations (in addition to bank and legal confirmations) considered likely to be relevant.
- Income tax returns and other information supplied to regulatory authorities.
- Shareholder records to identify the entity's principal shareholders.
- Statements of conflicts of interest from management and those charged with governance.
- Records of the entity's investments and those of its pension plans.
- Specific significant contracts and agreements not in the ordinary course of business, including those involving management and those charged with governance.
- Specific invoices and correspondence from law firms.
- Internal audit working papers.
- Whistle-blowing records.
- Records or documents associated with a public offering of the entity's securities, for example, prospectuses.

Sharing of Relevant Related Party Information Among the Engagement Team (Ref: Para. 13)

A9. Matters that are ordinarily addressed in the discussion among the engagement team include:

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

Understanding the Business Rationale of the Entity's Related Party Relationships and Transactions, and the Entity's Controls Over Them (Ref: Para. 15-16)

A10. Understanding the business rationale of the entity's related party relationships and transactions enables the auditor to assess whether their effects give rise to risks of material misstatements in the financial statements. Risks may arise particularly if the forms of the relationships and transactions do not represent their true economic substance. For example, although a relationship between the entity and a related party based overseas may involve routine transactions, it may also involve an underlying transfer pricing arrangement whose effects could result in material misstatements in the financial statements.

A11. The auditor may also seek to understand the business rationale of the related party transactions from the related parties' perspectives, as this may help the auditor better understand the transactions and why they were carried out. A business rationale from the related parties' perspectives that appears inconsistent with the nature of their businesses may represent a factor indicative of risks of material misstatements.

A12. Appropriate authorization and approval by management, those charged with governance, or, where applicable, the entity's shareholders, of related party transactions that are both significant and non-routine provide evidence that these have been duly considered at the appropriate levels within the entity. 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 a fraud risk. [proposed] ISA 240 (Redrafted) provides further guidance in responding to fraud risks.

A13. Relevant features of the control environment may include, for example:

- 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 related party transactions that are both significant and non-routine.
- Clear guidelines for the approval of related party transactions involving actual or perceived conflicts of interest.
- 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.

A14. Controls over related party relationships and transactions within some entities may be weak, inadequate or non-existent for a number of reasons, such as:

- The low importance attached by management to identifying and disclosing related party relationships and transactions;

- The lack of appropriate oversight by those charged with governance;
- An intentional disregard for such controls because related party disclosures may reveal information that management considers sensitive;
- An insufficient understanding by management of the disclosure requirements of the applicable financial reporting framework; or
- The absence of disclosure requirements under the applicable financial reporting framework.

A15. The absence of adequate controls over related party relationships and transactions increases the risks that management will not identify, appropriately account for, or disclose them. This may be particularly the case in a smaller entity environment, where management and those charged with governance are often the same. In such circumstances, the absence of independent oversight and approval of significant related party transactions increases the risks of material misstatements resulting from related parties.

A16. The auditor may obtain an understanding of the oversight exercised by those charged with governance through inquiries of them, or observing or reading minutes of meetings at which related party transactions are discussed and approved. This enables the auditor to gain an insight into the understanding those charged with governance have of the entity's related party relationships and transactions, the adequacy of their oversight, and the susceptibility of the entity to management override of controls.

A17. 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 there are related party relationships involving management, 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,[3] that are structured to misrepresent the financial position or financial performance of the entity.

[3] 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.

Substantive Procedures Responsive to the Risks of Material Misstatements Resulting from Related Parties (Ref: Para. 17)

A18. The nature, timing and extent of the substantive procedures that the auditor may select to respond to the assessed risks of material misstatements resulting from related parties depend upon the nature of those risks and the circumstances of the entity. [Proposed] ISA 330 (Redrafted) provides further guidance on considering the nature, timing and extent of further audit procedures.

A19. [Proposed] ISA 330 (Redrafted) requires the auditor to perform substantive procedures that specifically respond to significant risks. In the context of related parties, the purpose of further substantive procedures is primarily to respond to significant risks that (a) management has not identified or disclosed to the auditor related party relationships or transactions, or (b) management has not properly accounted for or, where required by the applicable financial reporting framework, disclosed specific related party transactions, whether due to fraud or error.

A20. Examples of further substantive procedures that the auditor may perform when the auditor has assessed a significant risk that management has not identified or disclosed to the auditor related party relationships or transactions include:

- Conducting a detailed review of accounting records for transactions with (a) specific characteristics, such as terms that deviate significantly from known market terms, or (b) unusual patterns or trends, such as regular advances to a third party. Such a review may be facilitated using computer-assisted audit techniques.
- Making inquiries, where practicable, of parties outside the entity who are presumed to have significant knowledge of the entity and its business, such as principal agents, major representatives, consultants, guarantors, or other close business partners.
- Investigating the entity's relationships with major suppliers and customers, such as inquiring of them as to whether they are related, reading their financial statements or other relevant financial information, or inquiring of relevant information sources regarding their ownership.
- Performing substantive analytical procedures on specific classes of transactions, such as lease expense or sales, to identify unusual relationships.
- Performing appropriate background searches using, for example, internet resources.

A21. Examples of further substantive procedures that the auditor may perform when the auditor has assessed a significant risk that management has not properly accounted for or, where required by the applicable financial reporting framework, disclosed specific related party transactions, whether due to fraud or error, include:

- Confirming or discussing specific aspects of the transactions with intermediaries such as banks, law firms, guarantors, or agents.
- Confirming the purposes, specific terms or amounts of the transactions with the related parties.

- Where applicable, reading the financial statements or other relevant financial information of the related parties for evidence of the accounting of the transactions in the related parties' books.

Response to a Significant Risk of Material Misstatement Regarding an Arm's Length Assertion (Ref: Para. 19)

A22. Management is responsible for substantiating any assertion that a related party transaction was conducted at arm's length. Such an assertion may explicitly state that the transaction was at arm's length or otherwise imply that the transaction was consummated on terms equivalent or similar to those prevailing in transactions with unrelated parties. Management's support for the assertion may include:

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

A23. Evaluating management's support for the arm's length assertion may involve one or more of the following:

(a) Considering the appropriateness of management's methodology for supporting the assertion;

(b) Verifying the source of the internal or external data supporting the assertion, and testing the data to determine their accuracy, completeness and relevance; and

(c) When the substantiation rests on significant assumptions, considering whether they reasonably support the assertion.

Written Representations (Ref: Para. 22)

A24. Obtaining written representations enables the auditor to gain confirmation from management and, where appropriate, those charged with governance that they have disclosed to the auditor all relevant information relating to identified related parties, and that they are not aware of any other related party matters required by the applicable financial reporting framework to be disclosed in the financial statements. Such representations effectively provide a way to emphasize to management and, where appropriate, those charged with governance their responsibility to disclose the identity of related parties to the auditor even if there have been no transactions with such parties. The representations may also address, where appropriate, specific related party issues, such as the existence of undisclosed side agreements on significant related party transactions.

A25. 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 party transactions.
- When they are responsible for the financial statements.

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

Materiality Considerations in Evaluating Misstatements

A26. A consideration of both the quantitative and qualitative aspects of a related party transaction is important in evaluating whether a misstatement to which it gives rise is material, because:

(a) The significance of the transaction may not depend solely on the recorded amount of the transaction but also on other specific relevant factors, such as the nature of the related party relationship (for example, the applicable financial reporting framework may deem transactions between the entity and those charged with governance to be significant regardless of the amounts involved); or

(b) There may be no objective basis for measuring the transaction.

Evaluation of Related Party Disclosures

A27. Evaluating the entity's related party disclosures means considering whether the facts and circumstances of the entity's related party relationships and transactions have been appropriately summarized and presented so that the disclosures are understandable.

A28. 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.

A29. Evaluating the effects of related party relationships and transactions also enables the auditor to consider whether, irrespective of the applicable financial reporting framework, these effects could result in the financial statements being misleading in view of the nature of the entity and its environment, the nature and objective of the financial statements, the applicable financial reporting framework and legal or regulatory requirements, and other matters (for example, events, transactions, conditions and practices that may have a significant effect on the audit).

Appendix

Related Party Definitions [4] when the Applicable Financial Reporting Framework does not Establish Related Party Requirements

Related party – A party is related to an entity if:

(a) Directly, or indirectly through one or more intermediaries, the party:

- (i) Controls, is controlled by, or is under common control with, the entity (this includes parents, subsidiaries and fellow subsidiaries);
- (ii) Has an interest in the entity that gives it significant influence over the entity; or
- (iii) Has joint control over the entity;

(b) The party is an associate (as defined in IAS 28, "Investments in Associates") of the entity;

(c) The party is a joint venture in which the entity is a venturer (see IAS 31, "Interests in Joint Ventures");

(d) The party is a member of the key management personnel of the entity or its parent;

(e) The party is a close member of the family of any individual referred to in (a) or (d);

(f) The party is an entity that is controlled, jointly controlled or significantly influenced by, or for which significant voting power in such entity resides with, directly or indirectly, any individual referred to in (d) or (e); or

(g) The party is a post-employment benefit plan for the benefit of employees of the entity, or of any entity that is a related party of the entity.

A related party transaction is a transfer of resources, services or obligations between related parties, regardless of whether a price is charged.

Close members of the family of an individual are those family members who may be expected to influence, or be influenced by, that individual in their dealings with the entity. They may include:

(a) The individual's domestic partner and children;

(b) Children of the individual's domestic partner; and

(c) Dependants of the individual or the individual's domestic partner.

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

Joint control is the contractually agreed sharing of control over an economic activity.

[4] These definitions are based on those set out in IAS 24, "Related Party Disclosures," extant as of December 9, 2005. For the audit of a public sector entity, the relevant related party definitions are those set out in International Public Sector Accounting Standard 20, "Related Party Disclosures," extant as of the same date.

Key management personnel are those persons having authority and responsibility for planning, directing and controlling the activities of the entity, directly or indirectly, including any director (whether executive or otherwise) of that entity.

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

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