

**IAASB Project Proposal — Related Parties****1. Subject**

Revision of ISA 550, *Related Parties*.

**2. Reasons the Subject Should Be Studied Now****MARKETPLACE DEVELOPMENTS**

The subject of related parties (“RPs”) and related party transactions (“RPTs”) is a significant topical issue. While the extent to which the accounting for RPs and RPTs was actually the cause or part of the cause of major recent corporate failures<sup>1</sup> is open to debate, the audit of, and accounting for, RPs and RPTs do appear to have played a prominent part in such failures.

ISA 550 was originally issued in October 1984 and had a minor revision as part of the codification process in March 1994. While this elapsed time should not in itself justify a major revision to ISA 550, there is a need to open the Standard for thorough review given the heightened attention on the proper accounting and auditing of RPs and RPTs. It is also timely to question whether the Standard still provides the most appropriate principles, essential procedures and guidance to deal with the common problem of the auditor failing to recognize RPs and RPTs and ensuring the completeness of their disclosure.

**SUFFICIENCY AND UNDERSTANDABILITY OF DISCLOSURES**

Significant issues have arisen in practice regarding the sufficiency and understandability of RP disclosures. In the widely publicized Enron case, the RP and RPT disclosures were admittedly indecipherable to even the most sophisticated investor. The issue has become so significant that the large firms wrote<sup>2</sup> to the U.S. SEC alleging that many public entities use boilerplate or very high level disclosures that provide little or no meaningful information, and asking the SEC to compel companies to provide more information on RPs and RPTs, including the purposes of transactions and any side commitments attached. Moreover, according to a 1997 UN analysis, two thirds of the 73 biggest banks and companies in East Asia did not disclose problem loans and other debts from RPs – the problem loans being one of the biggest reasons for the South East Asian financial crisis of 1997 - 1999<sup>3</sup>. The issue of sufficiency and understandability of disclosures is not merely an accounting problem. Auditors need to go further in fulfilling their responsibilities, in spite of the fact that they have always had to contend with the sensitive issue of disagreement with management when the accounting treatments or disclosures meet the letter but not the spirit of accounting standards.

**DEVELOPMENTS IN INTERNATIONAL AND NATIONAL STANDARDS**

The existing ISA 550 is a procedures-based Standard that was issued before ISA 310, “Knowledge of the Business”, ISA 400, “Risk Assessments and Internal Control”, and ISA 500, “Audit Evidence”, the three ISAs that are now subsumed within the Audit Risk Model (“ARM”)

<sup>1</sup> For example, Adelphia Communications and Enron.

<sup>2</sup> Reuters, January 4, 2002.

<sup>3</sup> Wall Street Journal, “A Number of Problems: Accounting Rules are less than Rigorous in Many Countries”, April 26, 1999.

project. Evidence from academic research<sup>4</sup> has supported the risk-based approach to the identification of RPs and RPTs, as well as fraud, based on the auditor's enhanced knowledge of the business and response to identified risks. Furthermore, the need for the auditor to maintain due professional skepticism in order to respond to the complexities of the RP subject matter is emphasized by the ARM in a way that the existing ISA 550 does not. Indeed, a U.S. ASB-sponsored study completed in 2000 of U.S. SEC enforcement action against auditors found that the auditors did not demonstrate an appropriate level of professional skepticism in 60% of the 45 cases where audit deficiencies involving, among others, RPTs and/or fraud were identified<sup>5</sup>. Thus, there is a compelling argument that ISA 550 should be revised into a risk-based Standard that conforms to the ARM principles and which will provide the auditor with the appropriate focus on understanding the business and responding to identified risks.

Moreover, a comparison of the existing ISA 550 with other corresponding national standards issued or revised after ISA 550 has highlighted a number of differences (see Appendix) that should now be considered.

For all these reasons, there is a need to consider additional guidance in ISA 550 to ensure that the Standard continues to provide a complete and relevant body of basic principles, essential procedures and guidance for the international profession.

### 3. Scope of Project

#### (a) LIST THE MAJOR PROBLEMS AND ISSUES THAT SHOULD BE ADDRESSED

Issues that should be addressed are grouped as follows:

##### Main scope considerations

- I. Risk-based approach
- II. Other structural considerations
- III. Scope exclusion

##### Other considerations

- IV. Sufficiency and understandability of disclosures
- V. Additional explanatory or other guidance

#### 1) RISK-BASED APPROACH

The existing procedures-based ISA 550 does not provide the most appropriate framework for the auditor to address the complexities of RP issues. A risk-based approach should be built into the Standard that would apply the ARM principles in the context of RPs. Issues to be addressed include:

##### With Respect to Understanding the Entity

- Whether the auditor should obtain, and document, a sufficient understanding of the nature and extent of the relationships involved, as well as the degree to which various components within

<sup>4</sup> See for example, "Why do Audits Fail? Evidence from Lincoln Savings and Loan" – Erickson, Mayhew and Felix, Journal of Accounting Research, Vol 38, No.1, Spring 2000.

<sup>5</sup> See "Top 10 Audit Deficiencies" – Beasley, Carcello and Hermanson, Journal of Accountancy, April 2001 issue.

and outside the reporting entity are influenced, for the purpose of identifying RPs and RPTs.

- Determining the circumstances when the use of industry or subject-matter experts is needed in order to understand the entity's business or the purpose of certain transactions that may involve RPs.

#### With Respect to Risk Assessment

- Whether the auditor should evaluate the potential for management's manipulation or concealment of RPs and RPTs for fraudulent or other purposes.
- Whether the auditor should consider factors that may increase the risk of material misstatement relating to identification and disclosure of RPs and RPTs, and in determining how to respond, such as:
  - A complex organizational or ownership structure, or so-called business empires
  - Management dominated by a single individual
  - Management lacking integrity
  - Existence of off-balance-sheet arrangements
  - Transactions involving the personal interests of management or otherwise involving conflicts of interest
  - The existence of aggressive incentive programs
  - Use of tax havens, transfer pricing arrangements or other tax-avoidance devices
  - Transactions that are highly unusual or complex or with vague terms
  - Lack of business purpose or substance
  - No passage of consideration, non-market prices or circular flow of money
  - Side commitments or other strings attached to transactions
  - Absence of competitive bidding
  - Inadequate internal control systems

Guidance could be provided regarding the underlying motivations of both sides of a RPT that may increase the risk of material misstatement, e.g. liquidity concerns, earnings management or deteriorating financial condition.

- Because the completeness assertion is directly linked to the internal control system, determining the circumstances when the auditor should evaluate the design and implementation (i.e. effectiveness) of the entity's internal control system for identifying and recording RPs and RPTs, as well as the entity's controls over management's ability to enter into RPTs – and not merely consider the adequacy of control procedures over the authorization and recording of RPTs, as currently required by ISA 550.10.
- Emphasizing that the risk of material misstatement may often be high in practice because many internal control systems are inherently deficient in that they are not designed to distinguish RPTs or otherwise capture RPTs that do not involve the exchange of consideration.

#### With Respect to Responding to Risk

- Whether additional guidance based on the ARM should be provided to the auditor in responding to identified risks, such as application of professional skepticism by all the engagement team members throughout the audit, assignment of more experienced staff to the engagement, increased involvement of partners and senior technical staff, and performance of extended or modified procedures to obtain more persuasive evidence.

- Whether the auditor should go beyond management in searching for RPs and RPTs, e.g. through inquiry with employees or other parties independent of management.

A revision of ISA 550 to conform to the ARM principles is recommended to ensure that the Standard appropriately directs the auditor to identify and respond to risks pertaining to RPs.

## II) OTHER STRUCTURAL CONSIDERATIONS

The existing ISA 550 provides lists of procedures that are both mandated (ISA 550.7) and suggested (ISA 550.12 and 550.14). Besides the fact that these lists underscore the procedural nature of the existing Standard, consideration should be given to whether they should be combined and mandated, and whether the project should identify additional relevant procedures and guidance in that regard.

## III) SCOPE EXCLUSION

### Requirements Prescribed by National Laws and Regulations

In many jurisdictions, the local laws and regulations define RPs differently from the accounting framework for their own specific purposes. They may also prescribe requirements relating to the identification and disclosure of RPs and RPTs that are additional to, or different from, those mandated by the accounting framework. Given the variety of definitions across jurisdictions, this project will specifically not address the reconciliations, conflicts or other issues that may arise when addressing the simultaneous requirements of the statutory, regulatory and accounting frameworks. However, guidance will be included in ISA 550 to highlight that the auditor should:

- Thoroughly understand the various definitions of RPs specified by the accounting, statutory and regulatory frameworks; and
- Pay particular attention to the additional or differing requirements of the local statutory and regulatory frameworks regarding identification and disclosure when performing work in relation to RPs and RPTs.

## IV) SUFFICIENCY AND UNDERSTANDABILITY OF DISCLOSURES

As discussed in Section 2 above, significant concern has been raised in practice that even where the financial reporting framework requires disclosure of related parties, actual disclosures fell short of the required standard in many instances.

The basic principle in ISA 550 paragraph 8 regarding disclosure states that “*Where the financial reporting framework requires disclosure of RP relationships, the auditor should be satisfied that the disclosure is adequate.*” This basic principle should be enhanced and clarified, and there should be further guidance regarding the standard of adequacy. Furthermore, disclosures cannot be described as adequate without being understandable to the users of the financial statements. Issues to be addressed therefore include:

- Whether criteria should be specified that would assist the auditor in judging adequacy and understandability of disclosures prescribed by the financial reporting framework – for example, conciseness, sufficiency, coherence, clarity of presentation, substance over form and whether the disclosures are meaningful to the average user of the financial statements.
- Where, based on the auditor’s knowledge and professional judgment, management’s disclosures are not adequate even though they comply with the requirements of the financial

reporting framework, whether the auditor should go beyond these requirements and ensure further disclosures are provided in order to meet the objective of true and fair representation for the financial statements.

- How should the auditor deal with practical constraints such as business confidentiality, whether arising from the operation of law or not, in the search for, and disclosure of, RPs?

V) ADDITIONAL EXPLANATORY OR OTHER GUIDANCE

- i) Consideration should be given to whether to expand guidance in the following specific areas

Area	Issues
Measurement	<ul style="list-style-type: none"> <li>• Considering providing guidance regarding the measurement of RPTs when there have been no substantive changes in ownership of the items transferred, or the benefit of services provided, on the premise that RPTs that are not in the normal course of operations require additional support for the substance of the transactions in order for the amounts of consideration exchanged to be used for financial reporting purposes.</li> </ul>
Planning	<ul style="list-style-type: none"> <li>• Considering whether additional guidance in planning is necessary, such as emphasizing that the auditor should always distribute a complete list of RPs as well as RP definitions to all engagement team members, including those performing work at other locations, prior to the start of the engagement, and that such a list should be updated and re-distributed as necessary throughout the engagement.</li> </ul>
Materiality	<ul style="list-style-type: none"> <li>• Considering providing guidance regarding the qualitative aspects of materiality as it applies to RPTs. Alternatively, a cross-reference to ISA 320 on Materiality (under revision) addressing the RP subject matter may achieve the same objective.</li> </ul>
Management representation	<ul style="list-style-type: none"> <li>• Emphasizing that the auditor should tailor the management representation letter to address specific RP issues, e.g. existence of side agreements with RPs on material contracts. Alternatively, a cross-reference to ISA 580 on Management Representations (proposed to be revised) addressing RPs may achieve the same objective.</li> <li>• If management provides a representation that a RPT has been conducted on an arm's length basis, and the auditor believes that the representation is unsubstantiated, determining whether the auditor should express a qualified or adverse opinion.</li> </ul>
SMEs	<ul style="list-style-type: none"> <li>• Moving the guidance in IAPS 1005 relating to RPs to ISA 550 and</li> </ul>

Area	Issues
	expanding such guidance as appropriate based on the discussions in this proposal, consistent with the objective of eliminating IAPS 1005 over time.
Confirmations	<ul style="list-style-type: none"> <li>Considering providing guidance regarding confirmations requested from RPs, since management may be able to influence the replies.</li> </ul>
Communications with those charged with governance	<ul style="list-style-type: none"> <li>Considering requiring the auditor to communicate with the audit committee or similar supervisory body, if applicable, regarding identified RPTs. Alternatively, considering including a cross-reference to ISA 260 (proposed to be revised) addressing the RP subject matter.</li> </ul>
Period coverage	<ul style="list-style-type: none"> <li>Clarifying that the directors should review for completeness information provided by the directors identifying material transactions with those parties that have been RPs for any part of the financial period under audit – ISA 550 is silent on this.</li> <li>Emphasizing that the auditor should review subsequent events for RPTs that occur after the period end that may impact the latest financial statements under audit.</li> </ul>

## ii) Differences with National Standards

The attached Appendix lists significant differences between national standards and ISA 550. This project will review these differences to determine whether they should form part of guidance in the revised ISA 550.

### (b) DESCRIBE ANY IMPLICATIONS FOR PERSONS OR GROUPS OTHER THAN THE IAASB

- IASB, with regards to any potential amendments to, or other implications for, IAS 24 arising from this project.
- IAASB Task Forces on ISA 240 (Fraud), 260 (Communications with those Charged with Governance), 300 (Planning), 320 (Materiality), 580 (Management Representations) and ARM.
- IFAC SMP Task Force to obtain guidance for impact relating to SMEs.
- CAG will likely have a keen interest in this project and should be consulted throughout the development of this project.

Other than the above, it is not expected that the project will impact on other IFAC committees or groups to any significant extent.

### (c) CONSIDER WHETHER IT REQUIRES PARTICULAR CONSIDERATION

There are no specific IT considerations.

**4. Indicate the Type of Material to Be Published**

Revision of existing ISA 550.

Proposed timeline:

- Formation of Task Force – July 2003
- Issues paper – February 2004
- First read – June 2004
- Exposure draft – September 2004
- Approved – June 2005
- Effective date – Financial periods commencing on or after January 1, 2006

**5. Resources Required**

- An IAASB task force of 4 – 5 people, of whom at least two are IAASB members.
- One IAASB technical staff member.

**6. List Important Sources of Information That Address the Matter Being Proposed**

- UK Auditing Standard SAS 460, Related Parties
- UK FRS 8, Related Party Disclosures (Oct 1995)
- CICA 6010, Audit of Related Party Transactions
- CICA 3840, Related Party Transactions
- Australian Auditing Standard AUS 518, Related Parties (Feb 2000)
- Australian Accounting Standard AASB 1017, Related Party Disclosures (Feb 1997)
- Australian Accounting Standard AAS 22, Related Party Disclosures (May 1993)
- US Auditing Standard, AU 334/SAS 45, Related Parties
- US Section 9334, Related Parties: Auditing Interpretations of Section 334
- AICPA, Accounting and Auditing for Related Parties and Related Party Transactions: A Toolkit for Accountants and Auditors (Dec 2001)
- AICPA, Fraud-Related SEC Enforcement Actions against Auditors: 1987-1997 (Aug 2000).
- US FASB 57, Related Party Disclosures
- CPA Journal December 2002, Due Professional Care in Cases of High Risk Engagement – Audit Lessons from Andersen and Enron
- AICPA Practice Alert No. 95-3, Auditing Related Parties and Related Party Transactions (1995, 1999)
- IAS 24, Related Party Disclosures (Issued March 1984; reformatted 1991)
- IASB, Proposed Improvements to IAS 24 – Exposure Draft May 2002)

**7. Factors That May Add To Complexity or Length of Project**

- Developments arising from the comments process for the ARM project.
- Developments arising from the ongoing work of current and future Task Forces such as Materiality, Documentation, Group Audits, etc.

Prepared by Ken Siong Date February 19, 2003

## Appendix: Summary of Major Differences with National Standards

National standards compared with ISA 550:

Australia – AUS 518

Canada – CICA 6010

UK – SAS 460

US – AU 334

<b>Differences</b>	<b>National Guidance</b>
<b>General</b>	
<ul style="list-style-type: none"> <li>Provides guidance regarding factors that make RPTs difficult to identify and measure</li> </ul>	AUS 518.06
<ul style="list-style-type: none"> <li>Provides expanded guidance regarding motivations that may give rise to RPTs</li> </ul>	AU 334.06
<ul style="list-style-type: none"> <li>Requires the auditor to consider the substance of the relationship and/or transaction being tested, not merely the legal form</li> </ul>	AUS 518.07
<b>Existence and Disclosure of RPs</b>	
<ul style="list-style-type: none"> <li>Provides additional examples of procedures to identify RPs and RPTs</li> </ul>	CICA 6010 (App) AU 334.07-08
<ul style="list-style-type: none"> <li>Provides guidance regarding reviewing the completeness of transactions with those parties that have been RPs for any part of the financial period.</li> </ul>	SAS 460.22
<b>Transactions with RPs</b>	
<ul style="list-style-type: none"> <li>Requires the auditor to be alert for transactions that may indicate the existence of previously unidentified RPs or RPTs (black letters vs. grey letters in ISA 550)</li> </ul>	AUS 518.17
<ul style="list-style-type: none"> <li>Provides guidance regarding the need to reassess risks concerning the identification of RPs and RPTs if the auditor identifies RPs/RPTs not previously identified</li> </ul>	AUS 518.21 CICA 6010.22
<b>Examining Identified RPTs</b>	
<ul style="list-style-type: none"> <li>Provides guidance regarding additional considerations related to recording and disclosing RPTs that are not in the normal course of operations</li> </ul>	CICA 6010.24



<b>Differences</b>	<b>National Guidance</b>
<p><b>Additional Topics</b></p> <ul style="list-style-type: none"> <li>• Requires a risk-based approach to the identification of RPs/RPTs (existing ISA 550 permits the auditor to limit audit procedures to certain procedures identified therein)</li> <li>• Provides guidance regarding the true and fair override (may depend on the financial reporting framework)</li> <li>• Provides guidance regarding the use of adjusted materiality levels, due to subjectivity in the measurement of certain RPTs and the fact that RPTs may be deemed material regardless of amount due to the nature of the transaction</li> <li>• Provides guidance regarding the importance of qualitative aspects of materiality when assessing the measurement and disclosure of RPTs</li> <li>• Requires the auditor to communicate with the audit committee regarding identified RPTs that are not in the normal course of operations and involve significant judgments made by management concerning measurement or disclosure</li> <li>• Measurement issues – fair values, valuation at year end.</li> </ul>	<p>AUS 518.08-13 CICA 6010.10-20</p> <p>SAS 460.5 AUS 518.25</p> <p>CICA 6010.06</p> <p>CICA 6010.28-30</p> <p>CICA 6010.23-25</p>

**Comments by Technical Managers/Committee Secretaries**

The comments of *each* Technical Manager are required before this Project Proposal is considered by the committee proposing to undertake the project.

**Secretary to FMAC**

CLASSIFICATION

*Class:* A

SUGGESTED PRIORITY

High.

OTHER COMMENTS

Signed Robin MathiesonDate April 21, 2003**Secretary to IAASB**

CLASSIFICATION

*Class:* A      B1      B2      C

SUGGESTED PRIORITY

OTHER COMMENTS

Signed \_\_\_\_\_

Date \_\_\_\_\_

**Secretary to Education**

CLASSIFICATION

*Class:* A

SUGGESTED PRIORITY

High.

OTHER COMMENTS

Signed Claire EganDate April 22, 2003

**Secretary to Ethics**

## CLASSIFICATION

*Class:* A

## SUGGESTED PRIORITY

High.

## OTHER COMMENTS

Signed Gill SpaulDate April 22, 2003**Secretary to Compliance**

## CLASSIFICATION

*Class:* A

## SUGGESTED PRIORITY

High.

## OTHER COMMENTS

Signed Peter JohnstonDate April 15, 2003**Secretary to PSC**

## CLASSIFICATION

*Class:* B1

## SUGGESTED PRIORITY

High.

## OTHER COMMENTS

PSC issued IPSAS 20, Related Party Disclosures, end of 2002 and has therefore an interest in this matter. Also a public sector perspective has been issued which relates to the Audit Risk Standards, which are closely related to this matter.

Signed Jerry GutuDate April 25, 2003

**Secretary to TAC**

## CLASSIFICATION

*Class:* A

## SUGGESTED PRIORITY

Medium.

## OTHER COMMENTS

The TAC would likely wish to provide input into the development of this project.

Signed Russell GuthrieDate April 17, 2003**Secretary to SMP Task Force**

## CLASSIFICATION

*Class:* A

## SUGGESTED PRIORITY

High.

## OTHER COMMENTS

This is of relevance to small firms since small entities often have related parties.

Signed Robin MathiesonDate April 21, 2003**Technical Director**

## CLASSIFICATION

*Class:* A      B1      B2      C

## SUGGESTED PRIORITY

## OTHER COMMENTS

Signed \_\_\_\_\_

Date \_\_\_\_\_