

INTERNATIONAL STANDARD ON AUDITING 550 (REVISED)

RELATED PARTIES MARKUP FROM SEPTEMBER DRAFT

(Effective for audits of financial statements for periods commencing on or after [Date])

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International Standard on Auditing (ISA) 550 (Revised), “Related Parties,” should be read in the context of the “Preface to the International Standards on Quality Control, Auditing, Assurance and Related Services,” which sets out the application and authority of ISAs.

Introduction

1. The purpose of this International Standard on Auditing (ISA) is to establish standards and provide guidance on the auditor's responsibilities and audit procedures regarding related parties, and transactions with such parties, when performing an audit of financial statements.
2. **The auditor should plan and perform the audit procedures designed to reduce to an acceptably low level the risks of not detecting material misstatements in the financial statements resulting from related party relationships and transactions.**
3. The auditor ordinarily addresses the risks of material misstatements resulting from related party relationships and transactions within the context of the applicable financial reporting framework. ~~Although~~ While an entity may enter into related party transactions as part of its normal business, such transactions may not be conducted at arm's length. Accordingly, financial reporting frameworks ordinarily require them to be disclosed so that users of the financial statements can understand the nature of the transactions and their financial effects. Financial reporting frameworks may also require disclosure of related party relationships to enable users to understand the nature of the relationships and their potential effects on the financial statements.
4. When the applicable financial reporting framework does not establish ~~such related party disclosure~~ requirements, ~~it is nevertheless important for~~ the auditor's procedures are limited to obtaining, ~~through the performance of risk assessment procedures,~~ an understanding (through performing the risk assessment procedures set out in paragraphs 9-36) of the nature and extent of the entity's related party relationships and transactions sufficient to evaluate (a) their significance, and (b) whether their effects could result in the financial statements ~~are likely to be being~~ misleading-¹ in the circumstances of the engagement.
45. The risk that the entity may 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 with~~ family members of management that are not fully documented or formally approved;
 - (c) Information systems may not be designed to ~~identify distinguish~~ or summarize transactions and outstanding balances between an entity and its related parties;

¹ 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. Section 110 of the IFAC Code of Ethics (Revised) requires a professional accountant not to be associated with misleading financial information unless a modified report is provided in respect of the information.

- (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; and
- (e) Transactions with related parties may be controlled, manipulated, or concealed by management for fraudulent or other purposes.

~~56. For these reasons, there is an inherent level of uncertainty associated with limitation regarding the auditor's ability to identify all the complete identification and appropriate accounting for and disclosure of related party relationships and transactions. Nevertheless, the auditor plans and performs the audit to obtain reasonable assurance of identifying material misstatements resulting from these relationships and transactions. Accordingly, there is an unavoidable risk that some material misstatements of 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.~~

Definitions

~~67. If the applicable financial reporting framework provides related party definitions, the auditor refers to those definitions for the purpose of the audit. The Appendix sets out This ISA refers to the definitions in International Accounting Standard 24² regarding related parties to assist the auditor in understanding the requirements standards and guidance of this ISA. If the applicable financial reporting framework provides different related party definitions, the auditor refers to those definitions for the purpose of the audit.~~

78. Other terms used in this ISA are:

- (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) ~~their~~ being in a position to advance their own personal interests contrary to their fiduciary responsibilities to ~~wards~~ the entity, or (ii) having ~~conflicting-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 as required by the applicable financial reporting framework.

Risk Assessment Procedures

89. The performance of the risk assessment procedures required by ISA 315, “Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement,” in relation to related parties involves:

² See ~~the~~ Appendix ~~4~~.

- (a) Inquiring of management regarding the entity's related parties and the nature of the transactions the entity has entered into with these parties, and discussing and communicating, as appropriate, related party matters among the engagement team during audit planning;
- ~~(a) A discussion of related party matters among the engagement team during audit planning;~~
- (b) Obtaining an understanding of the entity's related party relationships and transactions, and its environment in the context of related parties controls over them ("related party controls"); and
- (c) Performing ~~specific~~ procedures specifically directed towards identifying the identification of related party relationships and transactions not identified or disclosed by management, whether intentionally or not.

Inquiry of Management, Discussion Among the Engagement Team, and Communication to the Engagement Team

10. The auditor should inquire of management at the beginning of the audit regarding the identity of the entity's related parties and the nature of the transactions the entity has entered into with these parties.

11. Prior to undertaking any significant work, the auditor requests from management 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.

912. As part of the discussion among the engagement team required by ISA 315 When planning the audit, the auditor should ~~members of the team~~ discuss ~~with members of the engagement team~~ the susceptibility of the entity's financial statements to material misstatement resulting from related parties.

130. This discussion, which occurs as part of the discussion among the engagement team required by ISA 315, ordinarily addresses matters that include:

- The nature and extent of the entity's related party relationships and transactions.
- An emphasis on ~~T~~the importance of maintaining a proper state of mind throughout remaining alert during the audit ~~to~~ regarding the potential for material misstatement resulting from related parties, and the need to exercise appropriate professional skepticism; ~~for example, when reviewing bank and legal confirmations, and other third party confirmations.~~
- 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, ~~and~~ appropriate accounting for, and disclosure of related party relationships and transactions, and the related risk of management override of relevant controls.

14. The auditor should 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 Entity's Related Party Relationships and Transactions, and the Entity's Related Party Controls and Its Environment in the Context of Related Parties

~~151. When performing the risk assessment procedures required by ISA 315 to~~ In obtaining the understanding of the entity and its environment required by ISA 315, the auditor should obtain an understanding of:

- ~~(a) The nature and business rationale of the~~ entity's related party relationships and transactions, with its related parties; and
- ~~(b) The entity's the entity's related party controls, including controls for approving related party transactions, designed to mitigate the risks of material misstatement resulting from related parties.~~

Understanding the Nature and Business Rationale of the Entity's Relationships with its Related Parties Relationships and Transactions

~~12. In obtaining an understanding of the entity's relationships with its related parties as identified by management, the auditor considers the nature, extent and business rationale of these relationships.~~

~~163. Understanding~~ Considering the nature ~~and extent~~ of the entity's related party relationships involves ~~the auditor~~ obtaining an understanding ~~of as to~~ how the entity is controlled or significantly influenced,³ and how it controls or significantly influences other parties. Control or significant influence can ordinarily be recognized by considering a party's ownership interests in, or extent of voting power over, an entity.

~~17. Some circumstances may make it difficult for auditor to obtain~~ ing a full understanding of the nature of the control related party relationships can, however, be difficult, either because of the complexity of the issue (for example, the exercise of control or significant influence may occur indirectly through intermediate parties, or control may be exercised jointly with other parties), or because relationships with related parties may be concealed by management for fraudulent or other purposes. In some cases, the operation of effective control or significant influence may not be readily apparent for reasons such as 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;[;] ~~or~~
- 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.

³ The Appendix 4 provides examples of definitions of control and significant influence.

18. Where the entity is controlled by a party that appears to exert dominant influence over the entity, there is a greater 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 controlling party or indirectly with third parties related to the controlling party. In such circumstances, the auditor (a) seeks to identify the parties to which the controlling party is related, and (b) for those parties identified as such, understands the nature of the business relationships that they may have established with the entity. The auditor may obtain information about parties related to the controlling party, as well as transactions they may have entered into with the entity, through procedures that include, for example:
- Inquiries of, and discussion with, management and those charged with governance.
 - Inquiries of the controlling party or its auditor.
 - 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.
19. The auditor should 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 misstatement in the financial statements. In addition, for those related party transactions that are both significant and non-routine, the auditor should determine whether they have received high-level authorization and approval.
- ~~1420. Understanding the business rationale of the entity's related party relationships and transactions is relevant-assists the auditor in assessing whether their effects give rise to risks of material misstatement in evaluating the effects of the relationships on 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, if the entity has control over it may also involve an underlying transfer pricing arrangement whose effects could result in material misstatements in the financial statements with a related party, an understanding of the business rationale of the relationship and of the transfer pricing arrangement is necessary for the auditor to evaluate the related financial effects (including risks and contingencies) and their disclosure in the financial statements, especially when the related party is not consolidated.~~
21. The auditor may also seek to understand the business rationale of the related party transactions from both 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 misstatement.
22. High-level authorization and approval of related party transactions that are both significant and non-routine provide evidence that they have been duly considered by appropriate levels of management, and where applicable, those charged with governance. The existence of

transactions 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. ISA 240, "The Auditor's Responsibility to Consider Fraud in an Audit of Financial Statements," provides further guidance in responding to fraud risks.

- ~~15. In obtaining an understanding of the entity's related party relationships, the auditor considers, where practicable, the nature, extent and business rationale of the relationships that the entity's principal owners have with parties that are related to them (as defined by the applicable financial reporting framework), particularly when the principal owners exercise significant or dominant influence over the entity. When such influence exists, there is a higher risk of the owners overriding management to cause the entity to enter into non-arm's length transactions with other parties related to them. For this reason, it is important to understand the relationships among the various parties within a group that is controlled by dominant principal owners but that falls outside the requirements for consolidation under the applicable financial reporting framework.~~

Understanding the Entity's Related Party Controls

~~2316. The auditor obtains an understanding of the internal controls, including the control environment, that management has designed and implemented-established to mitigate the risks of material misstatements resulting from related parties. 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. Such controls include management's monitoring and other procedures to determine the completeness of identification and the appropriateness of the accounting for and disclosure of related party relationships and transactions in the financial statements.~~
 - ~~• 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.~~
- ~~17. It is particularly important to understand the controls that management has designed and implemented to approve significant related party transactions. Appropriate approval controls, which help to mitigate the risk of fraud, may require that specific types of related party~~

~~transactions or those that fall within specified criteria (such as those over a specified monetary amount, or those involving actual or perceived conflicts of interest) be reviewed and authorized by appropriate levels of management, by those charged with governance, or, if necessary, by the entity's shareholders.~~

~~24. The auditor also obtains an understanding of how those charged with governance oversee management's processes for identifying, accounting for, and disclosing related party relationships and transactions. This understanding may be obtained through inquiries of those charged with governance, or observing or reading minutes of meetings at which related party transactions are discussed and approved. This provides 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.~~

~~2518.~~ In obtaining an understanding of the entity's related party controls, the auditor also considers whether the existence of related parties in which management is known to have control, significant influence, or financial or other interests, may affect the potential for management to override controls. As discussed in ISA 240, "~~The Auditor's Responsibility to Consider Fraud in an Audit of Financial Statements,~~" 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 greater 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 ~~to commit fraud~~ 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 ~~such 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, that are structured to misrepresent the financial position or financial performance of the entity.

~~19. The auditor also obtains an understanding as to how those charged with governance exercise oversight of management's processes for identifying, accounting for, and disclosing related party relationships and transactions. Obtaining this understanding will provide an insight into the general level of awareness of those charged with governance regarding the nature, extent and business rationale 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. Such understanding may be gained through inquiries of those charged with governance, observing meetings at which related party transactions are discussed and approved, or reading minutes of such meetings.~~

260. Related party controls 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~~identification and disclosure~~;
- 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.

274. The absence of adequate controls over related party relationships and transactions increases the risks that ~~they~~management will not ~~be identified, or appropriately accounted for, or disclosed~~ them. This may be particularly the case in a smaller entity environment, where management and those charged with governance are often the same ~~individuals~~. In such circumstances, the absence of independent oversight and approval of significant related party transactions increases the risk of material misstatement resulting from related parties.

Specific Procedures Specifically Directed Towards Identifying the Identification of Related Party Relationships and Transactions not Identified or Disclosed by Management

282. Material misstatements resulting from related parties often arise from management's failure (whether intentional or not) by management to completely identify or disclose the entity's related party relationships and transactions. Accordingly, the auditor performs risk assessment procedures directed at to identify~~ing~~ related party relationships and transactions not identified or disclosed by management, notwithstanding the inherent uncertainty limitation referred to in paragraph 56 regarding complete identification.

29. These risk assessment procedures are directed primarily at identifying transactions that are both significant and non-routine as they have a greater risk of involving previously unidentified or undisclosed related parties. Such procedures comprise:

- (a) Inquiries of management and others within the entity; and
- (b) Review of relevant records or documents.

30. Transactions involving management or those charged with governance, or third parties related to them, are considered both significant and non-routine regardless of the amounts involved. Other transactions that are both significant and non-routine may include, for example:

- Significant equity transactions, such as corporate restructurings or acquisitions.
- The leasing of premises or the rendering of management services by the entity to another party if no consideration is exchanged.
- Significant sales transactions with unusually large discounts or returns.

- Significant transactions with circular arrangements, for example, sales with a commitment to repurchase.
- ~~23. The auditor should perform the following procedures designed to identify related party relationships and transactions not identified or disclosed by management:~~
- ~~(a) Make inquiries of individuals, other than management and those charged with governance, likely to have knowledge of related party relationships and transactions;~~
 - ~~(b) Review the following documentation for evidence of unidentified or undisclosed related party relationships and transactions:~~
 - ~~(i) Minutes of meetings of shareholders, management and those charged with governance;~~
 - ~~(ii) Shareholder records relating to the principal owners, and other relevant statutory records;~~
 - ~~(iii) Income tax returns and other information supplied to regulatory authorities; and~~
 - ~~(iv) Records of the entity's investments and, where practicable, those of its pension plans;~~
 - ~~(c) Identify significant and unusual transactions to evaluate whether related parties are involved; and~~
 - ~~(d) Identify special purpose entities that have some connection with the entity or its principal officers to evaluate whether they involve unidentified or undisclosed related party relationships or transactions.~~

~~Inquiries of Individuals Other than Management and Those Charged with Governance~~

31. To identify previously unidentified or undisclosed related party relationships and transactions, the auditor should inquire of management and others within the entity about the existence of transactions that are both significant and non-routine.

- ~~324. The auditor inquires of individuals other than management and those charged with governance Others within the entity of whom the auditor inquires are those the auditor considers likely to have knowledge regarding the possible existence of the entity's related party relationships or and transactions, not identified or disclosed by management. These individuals These include, for example to the extent that they do not form part of management:~~
- ~~(a) Those charged with governance;~~
 - ~~(ba) Personnel in a position to initiate, process or record transactions that are both significant and non-routineunusual transactions, and those who supervise or monitor such personnel;~~
 - ~~(cb) Internal audit;~~
 - ~~(de) In-house legal counsel; and~~

(~~e~~) The chief ethics officer or equivalent person.

33. To identify previously unidentified or undisclosed related party relationships and transactions, the auditor should also review the following records or documents for transactions that are both significant and non-routine:

- (a) Bank, legal and other third party confirmations obtained by the auditor;**
- (b) Minutes of meetings of shareholders and those charged with governance, and other relevant statutory records;**
- (c) Shareholder records, to identify the entity's principal shareholders; and**
- (d) Records of the entity's investments.**

34. In reviewing the records or documents set out in paragraph 33, the auditor may identify other information that may indicate the existence of previously unidentified or undisclosed related party relationships and transactions. Such other information includes, for example, guarantees and guarantor relationships, and loans or other advances to management, to those charged with governance, or to parties related to either.

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

- Income tax returns and other information supplied to regulatory authorities.**
- Records of investments of the entity's 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.**

36. If the auditor identifies transactions that are both significant and non-routine, the auditor should establish whether they involve known related parties. If they do not, the auditor should consider whether the circumstances of the transactions indicate the possible involvement of previously unidentified or undisclosed related parties.

Identification of Significant and Unusual Transactions

~~25. To assist in identifying related party relationships and transactions not identified or disclosed by management, the auditor performs procedures to identify significant and unusual transactions, and evaluates whether related parties are involved. Such significant and unusual transactions include, for example:~~

- ~~• Large equity transactions, such as corporate restructurings or acquisitions.~~
- ~~• Transactions involving management from which they may be expected to benefit financially.~~
- ~~• The leasing of premises or the rendering of management services by the entity to another party at no charge.~~

- ~~Significant sales transactions with unusually large discounts or returns.~~

Identification of Special Purpose Entities that Have Some Connection with the Entity or its Principal Officers

~~26. Special purpose entities, sometimes referred to as structured finance entities, are usually established for limited purposes, such as providing financing, liquidity, hedging or credit support. They may be structured in various ways, such as in the form of corporations, partnerships, trusts, or other types of arrangements. In many cases, they lack physical operating characteristics, and this makes it relatively easier for them to be set up and dissolved. In addition, these entities tend not to be consolidated and often do not issue financial statements. For these reasons, it is important that the auditor (a) identifies special purpose entities that have had some connection with the entity or its principal officers during the reporting period, and (b) evaluates the nature, extent and business rationale of these relationships to determine whether they involve unidentified or undisclosed related party relationships or transactions.~~

Assessment of the Risks of Material Misstatement Resulting from Related Parties

~~27. As part of the identification and assessment of risks of material misstatement required by ISA 315, the auditor identifies and assesses the risks of material misstatement resulting from related parties, and determines which of the identified risks are significant risks.~~

~~28. Risks of material misstatement resulting from related parties may arise not only in relation to the non-identification of related party relationships and transactions, but also when identified related party relationships and transactions are not appropriately accounted for or disclosed. Misstatements resulting from the inappropriate accounting for related party relationships and transactions may arise in various ways, such as:~~

- ~~Fraudulent financial reporting, for example, by accounting for the form and not the substance of the transactions.~~
- ~~Fraud through misappropriation of assets, for example, the execution of a significant unauthorized contract at below market value with a related party.~~
- ~~Errors in the financial statements, by not accounting for all the financial effects of the transactions as required by the applicable financial reporting framework (for example, not recognizing a related party transaction involving non-monetary consideration at fair value when required).~~

~~As ISA 240 indicates, those assessed risks that could result in a material misstatement due to fraud are significant risks.~~

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

Substantive Procedures Responsive to Assessed Risks

~~2937.~~ ISA 330, “The Auditor’s Procedures in Response to Assessed Risks,” requires the auditor to design and perform audit procedures whose nature, timing, and extent are responsive ~~respond~~ to the assessed risks of material misstatement at both the financial statement and assertion levels. This ISA focuses on specific responses at the assertion level only.

Testing the Operating Effectiveness of Internal Control

- ~~30. ISA 330 sets out the circumstances under which the auditor is required to perform tests of the operating effectiveness of controls, and explains the effect of reliance on controls on the extent of planned substantive procedures.~~
- ~~31. Testing the operating effectiveness of controls designed to mitigate the risks of material misstatement resulting from related parties is likely to be an appropriate response when controls exist for the identification, accounting for, and disclosure of related party relationships and transactions, and those controls are monitored by appropriate levels of management and, where applicable, those charged with governance.~~

Substantive Procedures Responsive to Assessed Risks

- ~~382. The nature, timing and extent of the substantive procedures that the auditor may select to respond to the assessed risks of material misstatement resulting from related parties depend upon the nature of those risks and the circumstances of the entity. ISA 330 provides further guidance on considering the nature, timing and extent of further audit procedures the nature, timing and extent of the substantive procedures that the auditor may design to respond to assessed risks of material misstatement resulting from related parties. Appendix 2 of ISA 240 lists possible audit procedures to respond to assessed risks of material misstatement due to fraud, some of which may also be relevant in addressing the assessed risks of material misstatement resulting from related parties.~~

Substantive Procedures Responsive to Significant Risks

- ~~33. Where the auditor has identified significant risks, the auditor:~~
- ~~(a) To the extent not already done, (i) evaluates the design of the entity's related party controls, and (ii) determines whether they have been implemented (paragraph 113 of ISA 315);~~
 - ~~(b) Obtains audit evidence about the operating effectiveness of these controls (on which the auditor plans to rely) from tests of control performed in the current period (paragraph 44 of ISA 330); and~~
 - ~~(c) Performs substantive procedures that specifically respond to the significant risks (paragraph 51 of ISA 330).~~
- ~~39. ISA 330 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 related party relationships or transactions, or (b) management has not properly accounted for or disclosed specific related party transactions, whether due to fraud or error.~~
- ~~34. The nature, timing and extent of substantive procedures that the auditor may perform to respond to significant risks depend upon the nature of those risks and the circumstances of the entity. For example:~~

~~Where the auditor identifies significant risks in relation to significant and unusual related party transactions, the auditor determines whether the transactions were properly~~

~~approved. In addition, where the identified risks are significant risks of fraud, the auditor follows the requirements and guidance in ISA 240 in responding to those risks, including obtaining an understanding of the business rationale of the transactions~~

~~• Where the identified risk is a significant risk regarding the accounting or disclosure of specific related party transactions, the auditor may perform further procedures to obtain corroborative audit evidence regarding the nature and business rationale of the transactions, such as:~~

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

~~•40. Where there identified risk is a significant risk that management has not ~~un~~identified or disclosed related party relationships or ~~and~~ transactions ~~may exist~~, the auditor may perform further substantive procedures such as:~~

- ~~- 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 requesting confirmation 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.~~

~~41. Where there is a significant risk that management has not properly accounted for or disclosed specific related party transactions, whether due to fraud or error, the auditor may perform further substantive procedures such as:~~

- ~~- 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.

~~35. If the auditor determines that a related party transaction has not been properly approved, and discussion with management and those charged with governance does not lead to a resolution of the matter, the auditor should consider the implications for the auditor's report.~~

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

42. In some unusual circumstances, the entity's disclosures may assert that a related party transaction has been conducted at arm's length. Although management may make such an assertion, it is ordinarily impracticable to substantiate it. Accordingly, a significant risk ordinarily exists that the assertion may be misstated.

43. When disclosure of a related party transaction indicates or implies that the transaction was conducted at arm's length, the auditor should obtain sufficient appropriate audit evidence that the assertion is not misstated.

44. 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. The auditor evaluates management's support for the assertion, which 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.

45. Evaluating management's support for the arm's length assertion involves 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.

46. If the auditor is unable to obtain sufficient appropriate audit evidence that an arm's length assertion is not misstated, the auditor should request management to withdraw the

assertion. If management disagrees, the auditor should consider the implications for the auditor's report.

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

4736. When If the auditor identifies related party relationships or transactions not previously identified or disclosed by management, the auditor should:

- (a) Promptly communicate **this information the identities of the newly identified related parties** to the rest of the engagement team to enable them to determine whether **this new information 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 **related party internal controls failed to enable did not lead to** the identification or disclosure of the related party relationships or transactions; and
- (d) **Evaluate whether it is necessary to reassess the risks of material misstatement resulting from related parties and, if so 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 representations responses from made by management and those charged with governance during the audit to the auditor's inquiries.**

48. In audits of smaller entities, the audit may be carried out entirely by the engagement partner (who may be a sole practitioner). In such a situation, the question of communication within the engagement team does not arise. Nevertheless, the engagement partner considers how information obtained about newly identified related party relationships or transactions affects the results of, and conclusions drawn from, other audit procedures already performed.

Communication with Those Charged with Governance

37. The auditor should discuss with those charged with governance the nature, extent and business rationale of significant related party relationships and transactions, including those involving actual or perceived conflicts of interest.

38. The discussion enables the auditor to:

- (a) **Confirm that those charged with governance are fully aware of the nature and extent of significant related party relationships and transactions and their effects on the financial statements;**
- (b) **Establish a common understanding with those charged with governance of the business rationale and propriety of the related party relationships and transactions, especially those involving actual or perceived conflicts of interest, and corroborate responses from management to inquiries the auditor has made into related party matters;**

- ~~(c) Alert those charged with governance to specific related party relationships and transactions of which they may not have been aware, to enable them to take appropriate action where necessary;~~
- ~~(d) Review with those charged with governance the completeness, accuracy and transparency of management's related party disclosures, and the appropriateness of the accounting for related party relationships and transactions; and~~
- ~~(e) Resolve identified related party issues, such as disagreements regarding the nature and extent of disclosure, on a timely basis.~~

Written Representations

349. The auditor should 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, completeness, accuracy and transparency** 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.**

450. Written representations include 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 to be disclosed in the financial statements in accordance with the applicable financial reporting framework. Such representations emphasize to management and, where appropriate, those charged with governance their responsibility to disclose the **identityies** 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.

451. 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 **regarding 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.
- ~~• When the auditor has determined that a significant risk of unidentified or undisclosed related party relationships or transactions exists.~~

Evaluation of Related Party Disclosures ~~and Reporting~~

~~42. Paragraph 13 of ISA 700, “The Independent Auditor’s Report on a Complete Set of General Purpose Financial Statements,” and paragraph 22 of proposed ISA 701, “The Independent Auditor’s Report on Other Historical Financial Information,” provide guidance on the auditor’s considerations when forming an opinion on the financial statements or other historical financial information, including evaluating related party disclosures.~~

Materiality Considerations in Evaluating Misstatements

~~4352.~~ When evaluating whether a ~~potential~~-misstatement resulting from relating to a related party transaction is material, the auditor considers both the quantitative and qualitative aspects of the ~~materiality of the~~ transaction, as because:

- (a) The monetary value of the transaction may not be relevant in evaluating the significance of the transaction; or
- (b) There may be no objective basis for measuring the transaction.

For example, the applicable financial reporting framework may deem transactions between the entity and those charged with governance to be material regardless of the amounts involved.

Evaluation of the Reasonableness of the Related Party Disclosures

53. The auditor should evaluate the sufficiency and appropriateness of audit evidence as to whether the related party disclosures in the financial statements are reasonable in the context of the entity’s applicable financial reporting framework.

~~454.~~ In evaluating the reasonableness of the entity’s related party disclosures, the auditor considers whether they ~~adequately and~~ appropriately summarize the facts and circumstances of the entity’s related party relationships and transactions ~~known to the auditor~~ so that they are understandable ~~and not misleading~~. Disclosures of related party transactions may not be understandable ~~potentially misleading~~ 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.

Disclosures Asserting Related Party Transactions to be at Arm’s Length

~~45. When disclosures of related party transactions state or otherwise suggest that the transactions were conducted at arm’s length, the auditor should obtain sufficient appropriate audit evidence regarding such assertion.~~

~~46. 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 suggest that the transaction was consummated on terms equivalent or similar to those prevailing in transactions with unrelated parties. The auditor evaluates management’s support for the assertion, which 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.~~
47. Evaluating management's support for the arm's length assertion involves 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.~~
48. ~~The form and nature of a related party transaction often make it impracticable for management to objectively substantiate an arm's length assertion.~~
49. ~~When the auditor is unable to obtain sufficient appropriate audit evidence regarding management's assertion that a related party transaction has been conducted at arm's length, the auditor should request that management withdraw the assertion. If management disagrees, the auditor should consider the implications for the auditor's report.~~

Discussion with Those Charged with Governance

55. The auditor should discuss with those charged with governance:

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

56. The discussion enables the auditor to:

- (a) Confirm that those charged with governance are fully aware of the nature and extent of significant related party relationships and transactions and their effects on the financial statements;
- (b) Establish a common understanding with those charged with governance of the business rationale and propriety of the related party relationships and transactions, especially those involving actual or perceived conflicts of interest, and corroborate management's responses to inquiries the auditor has made into related party matters;
- (c) Alert those charged with governance to specific related party relationships and transactions of which they may not have been aware, to enable them to take appropriate

action:

- (d) Review with those charged with governance the completeness, accuracy and understandability of management's related party disclosures, and the appropriateness of the accounting for related party relationships and transactions; and
- (e) Resolve identified related party issues, such as disagreements with management regarding the nature and extent of disclosure, on a timely basis.

Effective Date

~~570~~. This ISA is effective for audits of financial statements for periods commencing on or after [Date]. ~~Early application of this ISA is permitted.~~

Definitions in IAS 24 (Revised)

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.

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.

~~Amendments to ISAs 200 (Revised) and 700 (Revised), and Proposed ISA 705 as a Result of the Revision to ISA 550~~

~~ISA 200 (Revised), “Objective and General Principles Governing an Audit of Financial Statements”~~

The following paragraph in ISA 200 (Revised) is amended as marked:

- ~~20. Further, other limitations may affect the persuasiveness of audit evidence available to draw conclusions on particular assertions⁸ (for example, transactions between related parties). In these cases certain ISAs identify specified audit procedures which will, because of the nature of the particular assertions, provide sufficient appropriate audit evidence in the absence of:~~
- ~~(a) Unusual circumstances which increase the risk of material misstatement beyond that which would ordinarily be expected; or~~
 - ~~(b) Any indication that a material misstatement has occurred.~~

~~ISA 700 (Revised), “The Independent Auditor’s Report on a Complete Set of General Purpose Financial Statements”~~

The following paragraph in ISA 700 (Revised) is amended as marked:

- ~~13. Forming an opinion as to whether the financial statements give a true and fair view or are presented fairly, in all material respects, in accordance with the applicable financial reporting framework involves evaluating whether the financial statements have been prepared and presented in accordance with the specific requirements of the applicable financial reporting framework for particular classes of transactions, account balances and disclosures. This evaluation includes considering whether, in the context of the applicable financial reporting framework:~~
- ~~(a) The accounting policies selected and applied are consistent with the financial reporting framework and are appropriate in the circumstances;~~
 - ~~(b) The accounting estimates made by management are reasonable in the circumstances;~~
 - ~~(c) The information presented in the financial statements, including accounting policies, is relevant, reliable, comparable and understandable; and~~
 - ~~(d) Related party disclosures reflect the business rationale of material related party relationships and transactions, and are complete and accurate; and~~

⁸ Paragraphs 15–18 of ISA 500, “Audit Evidence,” discuss the use of assertions in obtaining audit evidence.

~~(ed) The financial statements provide sufficient disclosures to enable users to understand the effect of other material transactions and events on the information conveyed in the financial statements, for example, in the case of financial statements prepared in accordance with International Financial Reporting Standards (IFRSs), the entity's financial position, financial performance and cash flows.~~

Proposed ISA 705, “Modifications to the Opinion in the Independent Auditor’s Report”

The following paragraphs in proposed ISA 705 are amended as marked:

~~9. This ISA establishes three types of modified opinions, namely, a qualified opinion, an adverse opinion, and a disclaimer of opinion, the choice of which will depend upon the auditor’s judgment about the materiality and pervasiveness of the matter giving rise to the modification.~~

Disagreements with Management

~~(a) The auditor expresses a qualified opinion (see paragraph 25) when the auditor concludes that the effect of any disagreement with management, while material, is not pervasive; accordingly, except for the matter giving rise to the modification, the financial statements are prepared in accordance with the applicable financial reporting framework and are not misleading; thus they do not require an adverse opinion.~~

~~(b) The auditor expresses an adverse opinion (see paragraph 28) when the auditor concludes that the effect of a disagreement with management is material and pervasive to the financial statements such that a qualified opinion is not adequate to disclose the misleading nature of the financial statements.~~

Inability to Obtain Sufficient Appropriate Audit Evidence

~~(c) The auditor expresses a qualified opinion (see paragraph 25) when the auditor concludes that the possible effect of an inability to obtain sufficient appropriate audit evidence, while material, in the auditor’s judgment could not be pervasive; therefore, the financial statements are not misleading and do not require a disclaimer of opinion. This may be the case when it is possible to determine and clearly describe in the auditor’s report which financial statement line items or disclosures are or may be affected by the inability to obtain sufficient appropriate audit evidence.~~

~~(d) The auditor expresses a disclaimer of opinion (see paragraph 31) when the possible effect of an inability to obtain sufficient appropriate audit evidence is material and pervasive to the financial statements such that the auditor is unable to express an opinion on the financial statements.~~

~~See paragraph 23 for a discussion of materiality and paragraph 24 for a discussion of pervasiveness.~~

~~18. The auditor’s inability to obtain sufficient appropriate audit evidence may be imposed by circumstances. For example,~~

- ~~• When the timing of the auditor’s appointment is such that the auditor is unable to observe the counting of the physical inventories;~~

- ~~• When the entity's accounting records have been destroyed due to a fire.~~
- ~~• When the auditor determines that testing relevant related party controls is a necessary audit procedure but is unable to do so as (i) the internal control system has not been designed to identify, record, account for, and disclose related party relationships and transactions; or (ii) the design or implementation of the internal control system is inadequate for these purposes.~~

~~The auditor considers whether it is possible to perform alternative procedures to obtain sufficient appropriate audit evidence on which to base an unmodified opinion. If performing alternative procedures is not possible, the auditor will not be able to obtain sufficient appropriate audit evidence and, accordingly, qualifies the opinion or disclaims an opinion.~~

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