



April 30, 2006

Mr. Jim Sylph  
Technical Director  
International Federation of Accountants  
545 Fifth Avenue, 14th Floor  
New York, NY 10017

Dear Mr. Sylph:

We appreciate this opportunity to comment on the proposed International Standard on Auditing (ISA) 550 (Revised), *Related Parties*, (the “proposed standard”) as developed by the International Auditing and Assurance Standards Board (IAASB). Our letter consists of general comments about the proposed standard, which are followed by comments on specific paragraphs.

As requested in the explanatory memorandum accompanying the proposed standard, these comments include our views on the proposed requirement in paragraph 11(b) to perform procedures intended to identify related parties of any party that appears to actively exert dominant influence over the entity.

Within our recommendations for editorial changes, additions are noted in “bold underline” and deletions in “double strike-through.”

## **General Comments**

### ***Perception of the Extent of the Requirements and Application Material***

We agree that the overall objective of the proposed standard is for the auditor to obtain sufficient appropriate audit evidence about the identification and disclosure of related party relationships and transactions in the financial statements.

However, the proposed standard does contain extensive “suggested procedures” in the application material which, if the auditor were indeed to perform them, would significantly increase the work required.

The description of the responsibility of auditors to perform these suggested procedures in order to achieve the objectives of the ISAs is still subject to change under the “Clarity” project, and is only contained in the proposed revised Preface.

Accordingly, we are concerned that the implications of the application material contained in the proposed standard cannot be fully assessed until such time as its “status” can be clearly understood.

In addition, the proposed standard appears to require, or imply, that the auditor has to actively search for the types of relationships and transactions that are by definition extremely difficult to detect and easy to conceal, and the identification of which lies primarily with people other than the auditor. Above all, the identification lies with management.

Our other concerns are the lack of clarity regarding the extent of testing sought for “significant and non-routine transactions” which we discuss in a general comment below, and the extent of the requirements in paragraphs 11 and 15 and related application material.

We have included detailed comments on these paragraphs in the Comments by Paragraph section below. Further to our comments on paragraph 11, we have included an Appendix to our letter containing a proposed restructuring of paragraphs 9 through 12.

***Delimitation of Respective Responsibilities***

The proposed standard should emphasize that identification of the entity’s related parties and the nature of its related party relationships and transactions is primarily the responsibility of management, who is responsible for designing and implementing adequate internal control in this respect, and those charged with governance, who are responsible for overseeing management’s actions and ensuring that they receive sufficient appropriate information.

We believe that acknowledging and describing the respective responsibilities of management, those charged with governance, and the auditor in the Introduction section of the proposed standard would assist the reader in understanding the inherent limitation on the auditor’s ability to identify all related party relationships and transactions, as described in paragraphs 3 and 4.

***Clarification of the Extent of Testing for “Significant and Non-routine Transactions”***

The proposed standard uses the phrase “significant and non-routine” in several places to describe transactions. The auditor is required both to identify significant and non-routine transactions and to perform procedures on significant and non-routine transactions. Although we believe that the proposed standard needs to clarify the term “significant”, particularly in terms of its relationship to materiality, and the term “non-routine”, we agree conceptually with limiting tests to transactions that meet both criteria. For example, we believe that in performing procedures to identify previously undisclosed related parties, the auditor needs to inquire of management about transactions that meet *both* the significant and non-routine criteria.

The meaning of “significant and non-routine” seems to change in the proposed standard when used to describe related party transactions. This is primarily because of language in paragraph A4, which indicates that significant related party transactions are always non-routine. This guidance differs from the definition of “non-routine” provided in ISA 315, paragraph 110 (“Non-routine transactions are transactions that are unusual, either due to size or nature, and that therefore occur infrequently.”). We believe that the IAASB needs to address that difference.

In addition, we believe that as a result of the guidance in paragraph A4, some of the requirements in the proposed standard might be interpreted to require a greater scope of testing than is intended.

For example, paragraph 11(c) requires the auditor to review records and documents for transactions that are significant and non-routine to test for undisclosed or unidentified related parties. Taking the guidance of paragraph A4 into account, the requirement might be interpreted to mean that the scope of the review of records and documents shall be *all* significant transactions (as there is no distinction between routine and non-routine for related party transactions), which increases the scope of the testing significantly.

As another example, paragraph 15 requires the auditor to determine whether significant and non-routine related party transactions have been appropriately authorized and approved. Again, with the guidance in paragraph A4, the requirement might be interpreted to mean that the auditor shall determine whether *all* significant related party transactions have been authorized and approved, including those that are routine.

We recommend that the IAASB clarify the level of testing sought by either amending paragraph A4 or rewording the requirements.

### **Comments by Paragraph**

- **Overall**

Certain paragraphs in the proposed standard discuss the auditor’s determining whether related party transactions have been appropriately “accounted for”. For example, the objective in paragraph 6 includes language about obtaining sufficient appropriate audit evidence about the “accounting for” and disclosure of related party relationships and transactions, while paragraph 23 requires the auditor to evaluate whether the related party transactions have been “properly accounted for”.

We believe this language could be interpreted to mean that the auditor needs to trace the “debits and credits” of every related party transaction to the underlying accounting records. This seems to be extensive, going beyond the requirements of certain accounting frameworks such as IAS 24, which focuses on the disclosure of related parties and related party transactions, rather than the accounting for the transactions.

We recommend that the IAASB clarify the nature of the auditor's requirement.

- **Paragraph 3**

We suggest the following editorial change, as we believe that the entity may identify a related party, but still not appropriately account for the transactions with that related party for the reasons cited in the paragraph.

“The risk that the entity does not identify ~~and~~or appropriately account for...”

- **Paragraph 6**

We believe that the objectives described in paragraph 6(b) are applicable in all cases, including where the financial reporting framework does not establish requirements for related parties. We therefore suggest that the language in paragraph 6(b) be deleted, and 6(b)(i) and 6(b)(ii) become paragraphs 6(b) and 6(c), respectively.

- **Paragraph 10**

The auditor is required to obtain an understanding of “how the entity is controlled or significantly influenced”. We interpret this requirement to have a broader meaning than the referenced application material indicates, as it relates only to the *identification* of the controlling parties and does not offer guidance on other considerations related to control and influence.

We request that the IAASB clarify whether the requirement of understanding “how the entity is controlled” is limited to the identification of any controlling parties or controlling ownership interests. If a broader meaning is intended, we recommend adding guidance on other considerations of control or influence.

- **Paragraph 11(a)**

We are concerned that the auditor may have difficulty determining the scope of the requirement to inquire about “significant and non-routine” transactions, particularly given the application material in paragraphs A4 and A5.

Paragraph A4 implies that “significance” in the context of the requirement may have no relationship to materiality. Given the objectives in paragraph 6, this means that the financial statements may be “materially misstated” as a result of transactions which appear to be *significant* to the related parties involved, even though they are not material to the entity. In many cases, we do not believe that the auditor of the entity will be able to fairly assess what represents a “significant transaction” to a potentially unidentified related party of the entity. Therefore, the auditor is implicitly required to inquire of management regarding *all* non-routine transactions in order to meet the requirement of the proposed standard. This seems incongruous with the risk based approach of the proposed standard and furthermore is in contradiction with other statements of the standard which emphasize significant **and** non routine transactions. Accordingly, we believe that having to do that assessment as part of meeting the requirement is not appropriate.

We believe that the requirement intends for the auditor to inquire of management about the existence of any non-routine transactions that were of significance due to their size (based on materiality) or their nature or circumstances.

We recommend that a definition of “significant transaction” be provided in the proposed standard. Further, we recommend deleting the following sentence in paragraph A4:

“Transactions may be regarded as significant where they appear to be significant to the related parties even though not material to the entity.”

Paragraph A5 contains guidance about inquiring of “others within the entity”. We believe the proposed standard needs to be clearer about the extent of work the auditor is expected to perform. As currently written, the guidance is “open-ended”.

- **Paragraph 11(b)**

We are concerned with the requirement in paragraph 11(b) for several reasons:

- The concept of “dominant influence” is not supported by a definition in the proposed standard.
- The requirement may appear to place the primary responsibility for identifying “the parties to which the dominant party is related” on the auditor rather than on management.
- The requirement does not acknowledge the inherent limitation on the auditor’s ability to identify such parties.
- The requirement exceeds what can be reasonably expected from a diligent auditor performing an audit in compliance with the ISAs.
- The requirement is “open-ended” and could expose the auditor to unfair criticism or possible legal action in the event of subsequent discovery of a significant but undisclosed related party transaction involving a party that is related to the dominant party.

In addition, inquiries of the dominant party as described in paragraph A6 will most likely prove to be ineffective if concealment is desired by the parties. Similarly, background searches will involve a large amount of work in order to be effective. We believe background search procedures should not expand beyond what is already expected of the auditor during the client acceptance and continuance process.

We have proposed an alternative approach to the requirements of paragraphs 9 – 12 in the Appendix to this letter. As part of that approach, we recommend the deletion of paragraph 11(b), along with its related application material paragraph A6.

- **Paragraph 11(c)(i)**

We suggest that the proposed standard clarify the requirement related to reviewing bank and legal confirmations. We believe the intent is for the auditor to review bank and legal confirmations only in jurisdictions or circumstances where the auditor has obtained the confirmations (either by requirement or for other reasons). However, as written, the proposed standard may lead some to believe that there is a new requirement proposed for the auditor to obtain these confirmations. In that case, conforming amendments to ISA 500 and ISA 505 would need to be proposed.

Overall, we believe that the requirement is more appropriate as application material.

- **Paragraph 13**

In assessing the risk of misstatement resulting from related party transactions, the auditor's understanding of the nature of the business is an important factor in determining the likelihood of the existence of related party transactions. The understanding of the entity and its environment is gained through the application of requirements and guidance in ISA 315. The proposed standard references ISA 315, but only in the context of the engagement team's discussion. We suggest expanding the reference in the proposed standard to link the procedures in ISA 315 related to understanding the entity and its environment to the procedures related to the identification of related parties.

- **Paragraph 15**

We support the requirement to obtain an understanding of the business rationale of the related party relationships and transactions. However, we believe that the requirement to determine appropriate authorization and approval of transactions is more appropriate as application material as the procedures to meet that requirement provide evidence that a business rationale underlies a given related party transaction.

In addition, we believe that paragraph A11, which encourages the auditor to understand the business rationale *from the related parties' perspectives*, may be very difficult to implement since it implies the auditor has knowledge of the related party's business. We believe this guidance exceeds the auditor's expected usual scope of work.

- **Paragraphs 18 – 20**

Paragraph 18 indicates that "management may find it difficult to substantiate" an arm's length assertion. If management is incapable of obtaining sufficient evidence, it is more than likely that the auditors will be unable to obtain it either.

We believe that paragraph 18 should be deleted, and paragraph 19 changed as follows:

"When disclosure of a related party transaction indicates ~~or implies~~ that the transaction was conducted at arm's length..."

- **Paragraph 20**

We recommend that guidance be added to this paragraph (or its related application material) about whether the *significance* of the “arm’s length transaction” impacts the action taken by the auditor if the “arm’s length assertion” cannot be substantiated.

- **Paragraph 23**

Paragraph 4 indicates that related party relationships and transactions are hard to identify and the auditor will never be certain that all are identified even if the audit is properly planned and performed. However, the proposed standard does not discuss the impact of that uncertainty on the audit opinion (i.e., how much uncertainty can the auditor accept before it becomes a limitation of scope?). We believe that the proposed standard should address the implication on the audit opinion when sufficient audit evidence cannot be obtained.

- **Paragraph 24(a)**

The paragraph requires the auditor to report the details of related party transactions of which those charged with governance “may not have been aware”. As the auditor cannot be certain of which transactions those charged with governance are aware, this necessitates that the responsibility to determine a “*complete*” list of related parties lies with the auditor rather than with management. We believe this requirement exceeds the auditor’s expected usual scope of work.

- **Paragraph 25 (a)**

We suggest that the bullet be amended as follows:

“**The auditor’s understanding of** the identity of the entity’s related parties and the nature of the related party relationships **obtained from the procedures performed**”

- **Paragraphs A1, A10, A16, A24, A29**

We noted use of the present tense (e.g., “enables the auditor”) in each of these paragraphs. We suggest that the paragraphs be revised to eliminate use of the present tense by employing language similar to the following:

“... **may** ~~enables~~ the auditor to...”

- **Paragraph A8**

The wording in this paragraph (“the auditor **may** consider it appropriate to review other types of records or documents...”) is misleading as written. In some cases, these documents must be reviewed by the auditor for the purposes of performing audit procedures under other ISAs. The guidance here should not override other ISAs.

Therefore, we recommend that a footnote be inserted in this paragraph clarifying that the auditor is required to review certain of these documents in conjunction with audit procedures under other ISAs.

- **Paragraph A9**

We suggest the following editorial change to eliminate use of the word “ordinarily”:

“Matters that are ~~ordinarily~~ addressed in the discussion among the engagement team may include:”

- **Appendix**

The definition of “related parties” is driven by the applicable accounting framework. While recognizing that a guiding principle of the ISAs is their framework neutrality, we believe that the proposed standard should address the recent revisions to IAS 24, which removed the exemption for state-owned industries. This is a significant change which has a pervasive impact on many developing economies. We believe it would be useful to include this change in the Appendix to the proposed standard, and to include additional guidance about the impact of this change on the risk assessment process and related audit procedures.

We would be pleased to discuss our letter with you or your staff at your convenience. If you have any questions, please contact P. Nicholas Fraser at + 33 1 55 61 21 87.

Very truly yours,

Deloitte Touche Tohmatsu

*Appendix 1 - Ascertaining the Identity of the Entity's Related Parties and the Nature of Its Related Party Relationships and Transactions*

***Current Exposure Draft***

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, 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)

***Proposed wording***

9. 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.

10. Accordingly, the auditor shall ascertain the identity of the entity's related parties and the nature of its related party relationships and transactions by performing the following risk assessment procedures :

(a) 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 ;

(b) Obtain an understanding of how the entity is controlled or significantly influenced, and how it controls or significantly influences the related parties ;

*Transferred to 9. above*

(c) Inquire of management, and others within the entity if deemed necessary, about the substance of the relationships and the rationale of transactions identified by the auditor that :

- are both significant and non-routine and
- may indicate the existence of previously unidentified or undisclosed related party relationships or transactions,

for the purpose of evaluating whether related party relationships and transactions not identified

(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)

or not disclosed by management do exist.

*Deleted*

(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:

*To be transferred to Application Material*

(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.

*Merged into 10 (c) above*