May 1, 2006

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

Exposure Draft: ***Proposed International Standard on Auditing 550 (Revised), Related Parties***

Dear Mr. Sylph:

The American Institute of Certified Public Accountants (AICPA) is pleased to comment on the above-referenced exposure draft (the "ED"). We support the efforts of the International Auditing and Assurance Standards Board in developing guidance for auditors regarding related party relationships and transactions when performing an audit of financial statements. However, as more fully explained herein, we believe that the ED's emphasis on differential risk assessment and focus on related party transactions that are both "significant and routine" is misdirected. We believe that the auditor should consider all related party relationships and transactions when assessing risk. Further, the ED's procedures oriented to identifying previously undisclosed relationships and transactions should be presented as a response to the risk of material misstatement resulting from related parties rather than as risk assessment procedures.

Our comments on the ED are organized in the following ten categories:

1. Risk assessment procedures
2. Related parties in the context of an audit of the financial statements
3. Definitions
4. Sharing of relevant related party information among the engagement team
5. Understanding the business rationale and controls
6. Arm's-length assertions
7. Written representations
8. Communication with those charged with governance
9. Documentation
10. Application material

1. Risk assessment procedures

The ED emphasizes transactions that are both "significant and non-routine" as part of the auditor's risk assessment procedures. We believe that the auditor's risk assessment procedures should include the possibility of not identifying or disclosing relationships and transactions that may appear insignificant or be considered "routine." In fact, the application material (paragraph A4) attempts to significantly temper the required emphasis on "significant and non-routine" by indicating that

- transactions are significant if significant to the related party, even if immaterial to the entity, and
- transactions involving management or those charged with governance are non-routine.

Thus, we recommend strongly that the ED's risk assessment procedures be better balanced to identify *all* relationships and transactions with related parties and to then assess the risk of misstatement based on their characteristics.

In addition, the first bullet point above refers to significance to the related party. The auditor may have no basis for determining the significance of transactions to related parties. Related parties' financial information may not be available to (much less audited by) the auditor. We urge the IAASB to delete the guidance in paragraph A4 as it is impracticable.

Further, we believe that procedures such as those in paragraph 11 are improperly characterized as "risk assessment" procedures. Rather, for the reasons expressed in paragraphs 3 and 4 of the ED, we believe that procedures intended to identify related party relationships and transactions not previously identified or disclosed should be viewed and presented as a required response to the risk of material misstatement resulting from related parties, in a manner similar to the required audit procedures responsive to the risk of management override of controls in ISA 240 (paragraphs 74-76). Aside from their classification, we have other comments on the procedures in paragraph 11, which follow.

Paragraph 11(a) of the ED requires the auditor to inquire of management and others within the entity about the existence of transactions that are both significant and non-routine. In addition to the views expressed above, we are concerned with the practicability of implementing these inquiries. The first issue is the use of the term "significant and non-routine." This involves asking management and others about the existence of all such transactions – not just those involving related parties. The totality of "significant" transactions and "non-routine" transactions could be voluminous, and "non-routine" transactions can mean very different things to different people.

> We recognize that the term "significant non-routine transactions" is used in paragraph 110 of ISA 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* as one of the matters an auditor considers in determining those risks that require special audit consideration. We suggest that the consideration of related

parties in significant, non-routine transactions be related to those transactions identified as a result of the procedures applied pursuant to ISA 315.

If the IAASB retains the management inquiry requirement in paragraph 11(a), we recommend that the application material indicate that the auditor establish an understanding with management and others as to what transactions are considered "significant and non-routine." This could include factors such as recurring vs. non-recurring, and those transactions subject to normal systems processing.

Paragraph 11(b) of the ED requires, where a party appears to actively exert dominant influence over the entity, that the auditor 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. Our concerns with respect to this paragraph are:

1. The use of the phrase "appears to actively exert dominant influence." Dominant influence is introduced and used only here, it is not defined and it has uncertain meaning. Paragraph 10 uses the common terms "controlled or significantly influenced;" we question whether dominant influence is intended to mean more than significant influence but less than control. We believe that 11(b) is not necessary because a "dominant party" and its related parties are (or should be) parties related to the entity as defined by the applicable financial reporting framework or by default to the definitions contained in the Appendix to the ED.

2. The risk assessment procedures would be invoked only if the dominant party appeared to *actively* exert such influence. We believe that the criterion is the *ability* to exercise such influence, not whether it is currently exercised.

3. The assessment of risk is based on whether it *appears* that the influence is exerted. This dilutes the assessment criterion as it utilizes a subjective measure.

We strongly recommend that paragraph 11(b) be deleted. However, if it is retained, we suggest that it be clarified by revising it as follows:

> *Where a party has the ability to directly or indirectly control the entity, perform procedures intended to identify the parties to which the control party is related, and understand the nature of the business relationships that these parties may have established with the entity*

Paragraph 11(c) of the ED requires the auditor to "review appropriate records or documents for transactions that are both significant and non-routine, and for other information that may indicate the existence of previously unidentified or undisclosed related party relationships or transactions. Appropriate records or documents that the auditor reviews shall include:

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

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

We believe that specifying certain documents in the requirements may suggest that an auditor need not have the same concerns with respect to identifying related parties when reviewing other documents, including those listed in the application material. Further, the ISAs are intended to be framework neutral. Bank confirmations are not standardized throughout the world. In one country, a bank confirmation may provide audit evidence with respect to guarantees or collateral. In another country, the confirmation may only provide audit evidence with respect to the bank balance. We believe that the auditor should use his or her professional judgment in determining which documents to review and therefore recommend moving the documents listed in (i) and (ii) to the application material. Further, the application material should indicate that the auditor reviews these documents and records in an audit for a variety of other evidentiary purposes. However, in reviewing such documents and records, the auditor also remains alert to the possibility of undisclosed related party relationships and transactions.

2. Related parties in the context of an audit of the financial statements

Paragraph 3 begins:

"The risk that the entity does not identify and appropriately account for or disclose related party relationships and transactions may be higher for a number of reasons…."

We suggest that the first sentence should simply state that the risk may be "high". Alternatively, if "higher" is retained, the comparison of what the "risk" may be "higher" than needs to be completed: for example, higher than for those with unrelated or independent parties.

Paragraph 3(d) states:

"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."

We recommend that the sentence be revised to read, "Related party transactions are not conducted *at arm's-length*…" The example cited (a transaction without consideration) is more an issue of non-arm's-length than being outside the normal course of business. For example, an entity may provide administrative services for affiliates at little or no cost. While not priced at amounts that might be equivalent to those in an arm's-length transaction, the services are entirely within the normal course of business.

Additionally, the last sentence of paragraph 3 should not be directed exclusively to "fraud." We recommend that the sentence be reworded to state "resulting in a higher risk of material misstatement."

Paragraph 4 states:

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

We believe that the paragraph should be reworded as it appears that it was written in the context of the auditor's responsibilities with respect to fraud. We recommend that the paragraph be drafted, as follows:

> *An audit performed in accordance with ISAs cannot be expected to provide assurance that all related parties and related party transactions will be discovered. Nevertheless, during the course of the audit, the auditor should be aware that material related party transactions may exist that could affect the financial statements and of common ownership or management control relationships that may require disclosure even though there are no transactions.*

3. Definitions

Paragraph 7 states:

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

We are concerned that this establishes the Appendix definitions as a default standard rather than as a minimum standard.

We recommend that the Appendix definitions be set forth as a minimum where the applicable financial reporting framework has no related party requirements or includes related party definitions that are less comprehensive than those contained in International Accounting Standard No. 24, *Related Party Disclosures* (IAS 24). We believe that it is necessary for the auditor to consider the definitions as contained in the Appendix to the ED in order to adequately perform the risk assessment procedures required by the ED. For example, if a framework does not include family members in its related party definitions, we believe that the auditor still should consider family members in performing the ISA's risk assessment procedures.

Further, ***paragraph 23 (c)*** of the ED states that the auditor shall evaluate:

> "Irrespective of the applicable financial reporting framework, whether the effects of the related party relationships and transactions could result in the financial statements being misleading in the circumstances of the engagement."

Unless the definitions included in the Appendix to the ED are established as a minimum standard, we believe that the evaluation required by paragraph 23(c) will be difficult to perform. If the definitions are not established as a minimum standard, additional guidance as to how the auditor makes the evaluation is necessary. If the applicable financial reporting framework has no or limited requirements, the ED should refer the auditor to the disclosure requirements of IAS 24 to help the auditor evaluate the adequacy of disclosures as required by paragraph 23(c).

Additionally, we believe that the definition of an arm's-length transaction is not correct and should be deleted or corrected. Please see section 6 of this letter below on Arm's-Length Assertions.

4. Sharing of Relevant Related Party Information Among the Engagement Team

Paragraph 14 states:

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

We recommend adding "all members of" prior to "engagement team" in the paragraph. Otherwise, the paragraph appears to apply only to the participants in the brainstorming session.

Further, we urge the IAASB to add a cross-reference to the requirement to communicate related party information with other auditors, currently in the proposed ISA 600, *The Audit of Group Financial Statements*.

5. Understanding the Business Rationale and Controls

Paragraph 15 states:

> "…In addition, for those related party transactions that are both significant and non-routine, the auditor shall determine whether they have been appropriately authorized and approved."

We question why the auditor is only required to determine whether transactions that are both significant *and* non-routine have been appropriately authorized and approved. We believe that all related party transactions should be appropriately authorized and approved, even if "routine." We suggest changing "both significant and non-routine" to "significant *or* non-routine."

Paragraph 16: We recommend revising this paragraph as follows (new language in bold italics; deleted language in strikethrough):

> The auditor shall obtain an understanding of:
>
> (a) The internal control~~s, including the control environment, that~~ management has established ***for identifying, accounting for, and disclosing related party relationships and transactions*** to mitigate the risks of material misstatements resulting from related parties;
>
> (b) How those charged with governance oversee management's processes for ***establishment and implementation of those controls*** ~~identifying, accounting for, and disclosing related party relationships and transactions~~; and
>
> ~~(c) The specific controls that those charged with governance have implemented to mitigate the risk of management override of controls where related parties exist over which management is known to have control or significant influence, or in which management is known to have financial or other interests.~~

In this way, the *control* rather than the general control objective is described.

We recommend that 16(c) be deleted (or changed to a cross-reference) as the guidance is already included in ISA 240. The ED need not repeat guidance already included in other Standards.

6. Arm's-Length Assertions

We strongly believe that the IAASB's consideration of arm's-length transactions and assertions is flawed. The problems start with the ED's definition of an arm's-length transaction in paragraph 8(a) as "a transaction conducted on such terms and conditions as between a willing buyer and a willing seller ***acting as if they were unrelated*** and pursing their own best interests" (emphasis added).

Arm's-length transactions are not undertaken *as if* parties are unrelated – they are effected only by parties that are *in fact* unrelated. Using the definition in the ED, management could assert that a transaction with a related party "is" at arm's-length although it is never possible for related parties to negotiate totally free of the influence of the relationship.

At best, an assertion about a related party transaction being undertaken on arm's-length terms should be limited to asserting "equivalency" to arm's length terms. Such an assertion would be required to be supported by probative evidence and audited to the satisfaction of the auditor.

Even the comparison of recurring related party transactions (e.g., intercompany sales) to sales to independent parties may not provide reliable evidence that transactions have taken place on terms that are equivalent to arms-length. For example, independent parties might insist on price concessions for a volume of transactions equal to the intercompany transactions, but the related

parties may choose not to price the products with volume discounts for any number of reasons, including transfer pricing or tax considerations. An assertion that such inter-company transactions are priced at arm's-length might be quite simple under the ED definition, but at best the pricing is only "equivalent" to similar transactions with independent parties. We believe there are many similar examples of the fallacy of "arm's-length" equivalency.

In addition, ***Paragraph 18*** states:

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

As stated previously, by definition, no related party transaction can be "conducted at arm's length." At best, management of an entity might assert that a related party transaction was consummated on terms that it believes are equivalent to those that would prevail in an arm's-length transaction. We suggest revising the first sentence accordingly.

We suggest that the IAASB strengthen the "difficulty of substantiation" language as it ***is*** difficult to substantiate such an assertion because it will generally not be possible to determine whether a particular transaction would have taken place if the parties had not been related, or assuming it would have taken place, what the terms and manner of settlement would have been.

In this regard, we urge the IAASB to delete or revise the guidance in paragraph A23(c). The guidance suggests that an arm's-length assertion might be substantiated, even if based on significant assumptions. We believe that the guidance should state that such an assertion based on assumptions by its nature lacks the necessary objectivity and thus *cannot* be substantiated.

Paragraph 20 states:

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

It is not clear what is meant by "the implications for the auditor's report." We believe that the failure to withdraw such an assertion has an impact on more than just the auditor's report. We suggest that the last sentence of paragraph 20 be revised to require the auditor to consider the implications on the **audit, including the auditor's report**. Further, we suggest that the application material include guidance that the auditor should consult with legal counsel, consider the implications on management representations, and consider withdrawing from the engagement.

7. Written Representations

Paragraph 22 states:

> "The auditor shall obtain written representations from management and, where appropriate, those charged with governance concerning: … (c) The appropriateness of the accounting for related party relationships and transactions, having particular regard to their business rationale."

It is not clear whether the phrase "having particular regard to their business rationale" indicates that business rationales are to be specified in the written representations, or whether management and those charged with governance need only to be mindful of the business rationale when making other representations. We recommend that the business rationale concept be clarified in the application material.

8. Communication with Those Charged with Governance

Paragraph 24(a) requires that the auditor communicate with those charged with governance:

> "The nature, extent, business rationale and disclosure of significant related party relationships and transactions, including those involving actual or perceived conflicts of interest."

We believe that that communication is the responsibility of management, not the auditor, and that the auditor has a responsibility to determine that the communication has been made. Therefore, we recommend that the respective responsibilities be clarified in paragraph 24(a).

9. Documentation

Paragraph 25 states:

> "In addition to the documentation requirements of ISA 315 (Redrafted) and ISA 330 (Redrafted), and, where relevant, ISA 240 (Redrafted), "The Auditor's Responsibility to Consider Fraud in an Audit of Financial Statements," the auditor shall document:
>
> (a) The identity of the entity's related parties and the nature of the related party relationships; and
>
> (b) The procedures performed to comply with the requirement in paragraph 11(b), and, where applicable, any identified parties related to the dominant party referred to in that paragraph."

We question whether documentation requirements are necessary in every ISA. In that regard, we believe that 25(b) should be deleted. It is not incremental as it is covered by both ISA 230, *Audit Documentation*, and ISA 315.

10. Application material

Paragraph	Comment
A3	Our concerns are included under **Risk assessment procedures** above.
A4	A4 states that "significant transactions involving management or those charged with governance, or third parties related to them, are non-routine because of the nature of the related party relationships." The paragraph also provides examples of transactions "that are both significant and non-routine." We believe that the continuing emphasis on "non-routine" transactions is misdirected. It may be difficult to isolate related party transactions that are considered "non-routine" and the ED examples are inconsistent. *We believe that the emphasis should simply be on identifying all related parties and transactions* and not attempt to make non-substantive distinctions.
A5	We recommend adding human resources and sales and marketing as additional examples of others within the entity that would be considered likely to have knowledge of the entity's related party relationships and transactions.
A10	A10 provides an example that states "although a relationship between the entity and a related party based overseas may involve routine transactions, it may also involve an underlying transfer pricing arrangement whose effects could result in material misstatements in the financial statements." We question whether the example is appropriate as we cannot readily understand how a transfer pricing arrangement would result in a material misstatement. We recommend another example and request that the IAASB specify the nature of the misstatement. For example, sales of property to major shareholders at prices above or below current market prices may have attributes of capital contributions or dividends in substance, rather than transactions involving profit or loss.
A13	We suggest adding periodic reviews by internal audit as an additional example of a relevant feature of the control environment.
A17	Provides the following, as an example of possible fraud: • Fraudulently organizing the transfer of assets from or to management or others at amounts significantly above or below market value. We suggest that the second bullet point be deleted as non-market-price transactions do not necessarily constitute fraud.
A23	See our comment above under **Arm's-length assertions.**

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Thank you for the opportunity to comment on this Exposure Draft. If you have any questions regarding the comments in this letter, please contact Michael Glynn at +1 212 596 6250, mglynn@aicpa.org or Sharon Walker at +1 212 596 6026, swalker@aicpa.org.

Respectfully submitted,

/s/ Susan S. Jones
Chair, International Auditing Standards Subcommittee

/s/ George P. Fritz
Member, Auditing Standards Board
Chair, Related Parties Task Force