

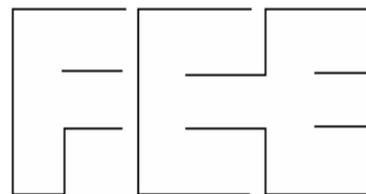
Date
20 June 2007

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Mr. J. Sylph
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International Auditing and Assurance Standards Board (IAASB)
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Edcomments@ifac.org

Dear Mr. Sylph,

**Re: Exposure Draft – Proposed Revised and Redrafted International Standard on Auditing (ISA) 550
“Related Parties”**

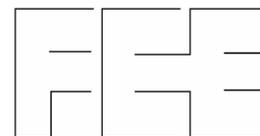
As the representative organisation of the European accountancy profession, FEE is pleased to comment on the Exposure Draft – Proposed Revised and Redrafted International Standard on Auditing (ISA) 550 on Related Parties (Proposed ISA 550).

1. Main Comments

Overall, FEE supports Proposed ISA 550 on “Related Parties”, as there were a number of significant issues with the Exposure Draft of April 2006. These have been addressed in Proposed ISA 550, including the balance and clearer demarcation between procedures that provide a reasonable basis for the identification and assessment of risks of material misstatement related to related parties and responses to assessed risks. Also improved are the recognition (albeit limited) that most related party transactions are routine and not high risk, the link between this ISA and the fraud ISA, the improved objective and changes made regarding dominant parties.

However, FEE believes that further significant improvements should be made:

- *Inherent Limitations of an Audit* – Despite the recognition of inherent limitations within this exposure draft, FEE believes that clearer and more comprehensive explanation of the limitations is needed to avoid unrealistic expectations of auditors by investors, regulators, preparers, etc.
- *Arm’s Length Transaction as a Significant Risk* - We are concerned that the requirement to treat management’s assertion that a related party transaction is carried at ‘arm’s length’ as a significant risk limits the auditor’s ability to apply their professional judgement.
- *Guidance on Implicit Arm’s Length Assertion* – In response to the question posed in the Explanatory Memorandum, FEE supports an approach in which both implicit and explicit assertions regarding related party transactions are covered.



2. Comments on Definitions

Paragraph 11: Definition of related party

FEE supports the new principle introduced by the IAASB to focus on the identification of those parties that are actively controlling or significantly influencing the entity.

We agree that the definitions in paragraph 11 (b) and (c) need to be sufficiently flexible to allow them to be adapted to the circumstances of a particular jurisdiction. We also agree that it is reasonable to set a minimum definition for the purpose of this Standard, which can be added to as dictated by the applicable financial reporting framework. However, we would like to repeat our concerns voiced in our letter dated 26 April 2006 on the initial Exposure Draft on ISA 550 'Related Parties' as to the practicalities of obtaining information from the entity which the entity itself is not required to provide. We comment on this further in Section 3 below 'Comments on Introduction'.

In relation to defining dominant influence and paragraph 11(b), which refers to a single individual or small group of individuals:

- We are unsure whether this is intended to include representatives of e.g., large powerful pension funds or private equity groups or to be restricted to individuals acting in a private capacity. We suggest that guidance on this would be helpful.
- Paragraph A20 adds further confusion, since it provides only examples of processes that have occurred in the past, such that we do not understand whether factual exercise of dominant influence (which would be evidenced and thus auditable) or the mere propensity for a party to "impose their will" at some future point in time (which may not be evidenced as easily if at all) is intended. We believe that it would be unreasonable to include the latter, since it may not be possible for the auditor to establish all potential dominant parties (e.g. the auditor may be able to establish parties who have control or majority control; however, in complex groups this may not be transparent, and the auditor is not in a position to determine whether or not close family members of such parties may be triggered by certain events to "impose their will" but remain silent the rest of the time).

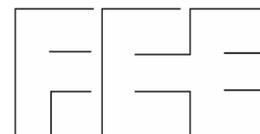
In respect of the definition of a related party, it should be noted that the International Accounting Standards Board (IASB) has issued in February 2007 an Exposure Draft of Proposed Amendments to IAS 24 on Related Party Disclosures on State-controlled Entities and the Definition of a Related Party, defining a related party differently, especially as far as entities under common control are concerned.

3. Comments on the Introduction

Paragraphs on inherent limitations

The inherent limitations in the audit of related parties need to be clearer and more comprehensive. It is the following combination of factors that presents the auditor with unusual difficulties:

- the factors listed in paragraph 3 explaining why related party relationships and transactions may give rise to higher risks of material misstatement are also factors that make it more difficult for the auditor to obtain sufficient appropriate audit evidence;
- transactions with related parties involving no exchange of consideration on the part of one party will often be especially difficult for the auditor to detect, as they may not be recorded in the same way as "normal" transactions;



- in respect of evaluation of the terms "at arms length" or otherwise, comparison with normal market prices or conditions may be unavailable. Paragraph A22 explains this further;
- where accounting and disclosure for related party relationships and transactions are not established by the relevant accounting framework the auditor may find it more difficult to obtain evidence;
- ISA 330 explains that in some circumstances substantive procedures may not be enough. If controls are ineffective or non-existent the auditor may find it difficult to obtain sufficient appropriate audit evidence, particularly in respect of informal related party relationships and transactions (e.g., with family members).

As regards the factors identified in paragraph 7, which are in addition to the matters referred to in paragraph 4:

- Management may be particularly unaware of parties under common control with the entity. The entity may not be aware itself of all such parties, particularly when the applicable financial reporting framework does not define such parties as related parties. The entity will most probably not have set up a system of controls to enable the identification of such parties and their transactions with the entity.

In addition:

- Paragraph A13 makes the further point that particularly in the case of larger, more complex entities, if controls are ineffective or non-existent the auditor may be unable to obtain sufficient appropriate audit evidence about related party relationships and transactions; alternatively,
- paragraph A16 explains that in smaller, owner-managed entities processes may be absent or controls informal, with the result that information may only be available through enquiry of the owner-manager.

The IAASB could build on the above two paragraphs to make the inherent limitations in the audit of related parties clearer and more comprehensive in Proposed ISA 550.

The expectations of financial statement users may be unrealistic in relation to related party accounting and disclosure. We strongly recommend that the Introductory section, and paragraph 7 in particular, should be expanded to explain better the limitations caused by the above combination of factors.

4. Comments on the Objective

In our view the objective should not add the sentence "*irrespective of whether the applicable financial reporting framework establishes related party requirements*", for the following reasons:

- (i) From a principles-based point of view, we believe an objective should not refer to a specific (series of) financial reporting framework(s). It also adds unnecessary detail. Such references should preferably be made within the application material.
- (ii) The IAASB has expressed its intention to create a more risk-based standard, *i.e.* based on the risk standards ISAs 315 and 330. From a risk-based perspective, paragraphs 10 (b) (i) and (ii) should always be met, which makes the sentence "*irrespective of (..)*" obsolete. A distinction between the situation where the financial reporting framework contains a definition of related parties or not could be made within the application material section.

Furthermore, the flow of the reasoning within paragraph 10 would be improved if paragraph 10 (a) would follow (instead of precede) paragraph 10 (b), because the fact of (not) obtaining sufficient appropriate audit evidence relies upon the auditor first obtaining an understanding and assessing risk. FEE suggests rephrasing the objectives as follows:

“The objectives of the auditor are:-

- (i) To obtain an understanding relevant to identifying the risks of material misstatement associated with related party relationships and transactions;*
- (ii) To identify fraud risk factors arising from related party transactions that are relevant to the identification and assessment of the risks of material misstatement due to fraud; and*
- (iii) To obtain sufficient appropriate audit evidence about whether related party relationships and transactions have been appropriately accounted for and disclosed in accordance with the applicable accounting framework.”*

5. Comments on Requirements

Paragraphs 14 and 15

FEE draws the IAASB’s attention to the fact that there seems to be a difference in requirements regarding the understanding of an entity’s related party relationships and transactions, depending on the degree to which the applicable financial reporting framework contains related party requirements.

FEE is of the opinion that paragraph 15 stands as a requirement without the first sentence of the paragraph: *‘If the applicable financial reporting framework establishes minimal or no related party requirements’*, which we suggest be deleted. FEE would also like to suggest that paragraph 14 (a) be added to paragraph 15, in order to form 15 (c). When these conditions are met, FEE believes that the remainder of paragraph 14 could be deleted, so that one principles-based requirement could be created covering virtually all situations, and independent of whether the applicable financial reporting framework contains (or not) related party requirements.

Paragraph 16

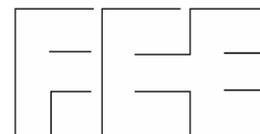
FEE requests IAASB to clarify in the application material what the sentence *“and by performing other procedures considered appropriate”* means.

Furthermore, FEE suggests adding the word ‘identify’ before ‘authorize and approve’ in paragraphs 16 (b) and (c), as has been done in paragraph 16 (a). Furthermore, Paragraph 16 (a) could be clarified by dropping the reference to the applicable financial reporting framework, as follows:

‘Identify, account for, and, if necessary, disclose related party relationships and transactions’.

Paragraph 21

We do not agree with paragraph 21 requiring that certain related party risks are deemed *always* to be significant risks. ISA 315 (December 2006 version) states that inherent risks are significant only where their nature, magnitude and likelihood are such that they require special audit consideration. Consistent with our comments elsewhere that as far as practicable a principles-based approach should be applied, in our view auditors should use their professional judgment to assess whether related party risks are significant, taking account of the nature, magnitude and likelihood of the potential misstatement.



We recognise, in line with our comments on the Introduction, that related party relationships and transactions on the whole give rise to higher inherent risks. Further, significant related party transactions outside the normal course of business and fraud risks will often meet the definition of significant risks and as stipulated in ISA (Redrafted) 240.27 fraud risks are significant risks. However, there will be circumstances where transactions with related parties (e.g. subsidiaries) are non-complex transactions conducted on the same terms and arrangements as transactions with external parties in the normal course of business. An assertion regarding such transactions, whether explicit or implicit, would not represent a significant risk in all circumstances. We note also that many organisations, such as the OECD, are encouraging companies to disclose that transactions with subsidiaries are conducted at arm's length to promote fair-trading globally. The proposed approach in the Exposure Draft could discourage such disclosures.

We believe it is unnecessary to refer in paragraph 21 specifically to management's assertion as regards whether transactions were conducted on terms equivalent or similar to those prevailing in an arm's length or market transaction. Firstly, as stated elsewhere in this letter we consider the audit considerations are the same whether management's assertion is explicit or implicit. Secondly, whether the risk related to the type of transactions referred to in the second bullet of existing paragraph 21 is a significant risk will depend on application of ISA 315 criteria.

Accordingly, FEE recommends that existing paragraph 21 is replaced with the following:

"The auditor shall treat fraud risks as significant risks and presume that significant related party transactions are to be treated as significant risks, in accordance with ISA 315 (Redrafted), unless this presumption can be rebutted and the circumstances are documented."

If the IAASB considers that further guidance or explanation is required this should be provided in the application material.

Paragraph 23

The 'if'-condition can be omitted as this should be done regardless of the fact whether there is a framework defining 'related parties' or not.

Paragraph 27

Although we acknowledge that it is easier for the auditor to obtain written representations in respect of related parties when the latter are defined in the applicable financial reporting framework, FEE believes the reference to the applicable financial reporting framework could be omitted, in order to create a principles-based requirement. More specifically, regarding paragraph 27 (b), FEE suggests omitting the phrase "*in accordance with the requirements of the framework*", as the word "appropriately" already allows for the flexibility related to the existence of a financial reporting framework.

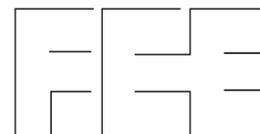
6. Responses to questions

Question 1: Views on whether the proposed ISA definition of a related party is appropriate

We refer to 2. Comments on definitions.

Question 2: Views on whether the proposed ISA should address the auditing implications of implicit arm's length assertions that management has made for related party transactions. If respondents support the provision of specific guidance, respondents are asked for their views on an appropriate approach, bearing in mind that there would be a need to distinguish between explicit and implicit arm's length assertions.

Paragraph 25 states "*When management has made an assertion in the financial statements stating that a related party transaction was conducted on terms equivalent or similar to those prevailing in an arm's*



length transaction or transaction under normal market conditions (..)". FEE interprets this sentence as if the text only covers explicit assertions regarding related party transactions. FEE is of the opinion that it doesn't matter whether management has explicitly made or disclosed such an assertion, *i.e.* that a distinction between implicit and explicit assertions needn't be made. The same issue arises in other paragraphs, such as paragraph 21 second bullet.

For this reason, FEE believes that the auditor's response to risks of material misstatement associated with related party relationships and transactions should cover both explicit and implicit assertions in the same way as is currently proposed in the requirements in paragraphs 22 to 26. The same reasoning is valid for the application material in paragraphs A23 to A37. FEE therefore suggests that the Standard be amended to include guidance to point out that assertions may not necessarily be explicit, and that the requirements of this Standard apply equally to implicit assertions, such that auditors will act consistently irrespective of whether such assertions are implicit or explicit.

7. Considerations for smaller entities

Paragraphs A14 and A15 are good descriptions of small and medium-sized situations. In paragraph A14 it should be added that in practice, very often bank loans are supported by personal guarantees and/or private assets as collaterals from the owner-manager.

For smaller entities, the auditor may need to explain to the client what related party transactions consist of, in a similar way in which auditors need to explain to their clients what accounting estimates (Proposed ISA 540) consist of.

Furthermore, paragraph A16 is unbalanced. In an owner-manager business, -the integrity of the owner-manager will play an important role regarding the control environment. The owner-manager in a small business may either mitigate *or exacerbate* some of the risks that may arise from related party transactions.

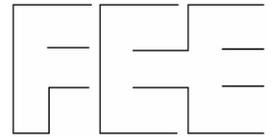
Paragraphs A16 and A32 include considerations specific to smaller entities. FEE is not convinced that these two paragraphs are helpful when performing an audit of a smaller entity, as they represent general comments which are obvious and do not provide any further guidance.

8. Compliance Framework and Misleading Financial Statements

The auditor override for compliance only frameworks (misleading test designed to exceed the requirements of the financial reporting framework) remains problematical. This is reflected in the introduction (paragraph 5 (a), the objective (Paragraph 10 (b) (i) b.), the requirement on forming an opinion (paragraph 26 (b) (ii)). There is a need to include a reference to ISA 700, but make it clear that the "misleading test" does not go beyond this. FEE refers to the comments on the inherent limitations of an audit (see above in 3. Comments on Introduction, paragraph 7).

9. Translation and other issues

FEE suggests IAASB uses the terminology "**audit** procedures" instead of "procedures" and "**audit** evidence" instead of "evidence" (e.g. Paragraph 24 (b)), following the amendments to the audit risk model (first new version) dating from October 2003 and the related conforming amendments made by the IAASB in February 2004, in order not to create translation uncertainties concerning the words used in the context of the IAASB Glossary.



If you have any further questions about our views on these matters, please do not hesitate to contact us.

Yours sincerely,

Jacques Potdevin
President