



Organización Internacional de Comisiones de Valores
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June 2, 2006

Mr. James Sylph
Technical Director
International Auditing and Assurance Standards Board
545 Fifth Avenue, 14th Floor
New York, NY 10017

Email Edcomments@ifac.org

Re: IAASB Exposure Draft ISA 550 (Revised) Related Parties (ED)

Dear Mr. Sylph:

IOSCO's Standing Committee No. 1 on Multinational Disclosure and Accounting appreciates the opportunity to comment on the IAASB's December 2005 Exposure Draft of proposed changes to ISA 550 (Revised) Related Parties (ED).

As an international organization of securities regulators representing the public interest, IOSCO Standing Committee No. 1 (SC 1) is committed to enhancing the integrity of international markets through promotion of high quality accounting, auditing, and professional standards. Our comments in this letter reflect those matters on which we have achieved a consensus among the members of SC 1 and are not intended to include all comments that might be provided by individual members on behalf of their respective jurisdictions.

We welcome the proposed ED as evidence of the recognition of the importance and complexity of identifying related parties and auditing related party transactions. However, we believe that the content of this ED should be further strengthened to provide a more robust approach to the audit of related parties. In this letter, we outline our main concerns as to how the Related Parties standard should be improved, and provide some additional detailed comments in the Attachment.

The new format for clarity.

We noted that the ED is presented in the new format that has been proposed to clarify the ISAs. We submitted a comment letter on the clarity format on February 27, 2006. We would refer you to that comment letter on clarity and underscore the points we made therein, as those comments continue to be the context for all points we make in commenting on this ED. We will generally not repeat comments we have already made in our previous letter.

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The Objective

We believe the objective in the ED should be developed further. As now written, it does not clearly and sufficiently communicate the objective of an auditor's work in terms of the *outcome* to be achieved. Instead the objective reflects a summary of the later requirements. We suggest that the objective should focus on the need for auditors to ascertain the effects of material related party relationships and transactions within an applicable financial reporting framework. Any inherent limitations of an audit in this area do not seem to us to be appropriate statements to put into an Introduction of a standard or to otherwise precede or accompany objectives. If there is a need to provide coverage of the limitations of an audit, we believe this should be covered in discussing the overall general objectives of an audit under ISA 200, not repeated in every individual ISA. It conveys an inappropriate message in ISAs to focus on what an audit cannot do, when the goal is to give clear direction to auditors as to what they should do.

Focus on professional scepticism and paragraph 4

Given the nature and complexity of related parties and related party transactions, there is a much higher risk that an entity may not identify, disclose and appropriately account for related party transactions. By definition, related party transactions could almost never be at arm's length. The question is then whether the terms in the related party transactions are similar to those of an arm's length transaction. If management makes an assertion that the transaction(s) are conducted at arm's length or on terms similar to arm's length, the auditor should obtain audit evidence supporting the statement. In many instances it may be difficult to substantiate whether the terms of related party transactions are similar to those that would be in a similar arms length transaction. It is critical that the auditor is alert to these risks and exercises professional skepticism. Though it is important to have legitimate expectations of what the auditor can undertake, the auditing standard on related parties should emphasise the need for the auditor to maintain a high degree of professional skepticism.

In paragraph 4 the emphasis is more on the 'unavoidable risk' that some material misstatements may arise from related party transactions which will not be detected by the auditor. This conveys a rather negative and unfavourable message of what the auditor is capable of doing.

We would suggest that paragraph 4 is not beneficial. As noted above, it expresses the inherent limitations in an audit that would be better covered as general statements in ISA 200. It would be more helpful, and provide a better tone for the ED, if this paragraph emphasised the need for auditors to maintain professional skepticism throughout their audit of related parties and related party transactions.

Financial reporting framework and the auditor's avoidance of association with misleading information

Paragraph 7 of the ED states that where the applicable financial reporting framework establishes related party requirements, the definitions set out in that framework apply for the purpose of the audit, and where the applicable accounting framework does not establish related party requirements, the definitions set out in the Appendix (which presents IAS 24 definitions) apply for the purpose of this ISA.

What should an auditor do if the applicable accounting framework contains a definition of related parties that would encompass a much smaller category of parties to the point that the auditor believes that the financial statements are misleading?

We understand that under the IFAC Code the auditor may not be associated with misleading information, and we can see that Paragraph 23 (c) and Footnote 2 endeavours to deal with this situation; however we are concerned that the combination of this sub-paragraph and footnote 2 may not be sufficient to guide the auditor. We believe this standard should further address situations in which information is materially misleading due to a lack of information about related parties.

Significant and non-routine transactions

The risk of non-identification of related parties, other than those notified by management, is covered in paragraph 11. The emphasis in sub-paragraphs (a) and (c) is on identifying significant and non-routine transactions that may indicate the presence of previously unidentified related parties. We raise two matters about this approach: the lack of context and the extent of the requirements.

Lack of context

We believe it would be helpful to provide more context regarding risk factors of what the auditor should evaluate in paragraph 10 before identifying significant and non-routine transactions for related parties in paragraph 11. For example, the auditor might want to evaluate the overall risk of unidentified related party transactions if there are many overseas entities, if other auditors are used or there are complex group structures. This might provide an indication of the risk of unidentified related parties which would help focus the audit work on the risk of unidentified related parties and transactions.

Extent of requirements

The mandatory requirements in paragraph 11 (c) seem rather limited. We believe that some additional requirements that would be applicable in audit engagements should be included here. Bullet point 6 from A 8 should be included. Some comparison of identified related parties with previous years would also seem necessary.

We believe it should be highlighted more strongly that some of the types of records or documents included in Application Material A 8 would be reviewed in *all* circumstances to which they are applicable. Review of such records might not be applicable in all engagements, however, when they are available, they should be reviewed.

Concept of dominant influence

In paragraph 11(b), the ED introduces the concept of dominant influence. However, we would welcome more explanation about what it is, how it arises and how it would be demonstrated. We understand it may include the over-riding influence of an individual as exhibited in some high profile company frauds. However, this is not clear from the paragraph.

Special-purpose Entities

We are concerned that the Board has not made greater mention of SPEs in the proposed standard. The only coverage is a single brief mention in paragraph A17 in the Application Material. SPEs are not rare in public companies around the world, and even in other audits, we believe an audit standard should promote awareness and understanding that such entities may exist and may be related parties. Such a possibility is not adequately addressed by an assumption that the condition would be discovered in a

search for non-routine transactions. We believe it is very important to provide additional coverage of this topic in both the requirements and application section of the standard.

Some of the actions now covered only in the Application Material should be included in the Requirements Section

We would suggest that the following actions should be included in the requirements section as they would be applicable in virtually all engagements.

Paragraph 11 c – include bullet 6 from A 8 "Specific significant contracts and agreements not in the ordinary course of business, including those involving management and those charged with governance" as part of requirements.

Paragraph 19 -- include (b) from A 23, "Verifying the source of the internal or external data supporting the assertion, and testing the data to determine their accuracy, completeness, and relevance".. The other two elements from A 23 may also be necessary in some circumstances (it would depend on the assertion), but it would seem to us that A23 (b) is always applicable.

Questions regarding any of the comments in this letter may be directed to me or to Susan Koski-Grafer on 202-551-5300.

Yours truly,

A handwritten signature in black ink that reads "Scott A. Taub" with a small "CMT" to the right.

Scott A. Taub, Chairman
IOSCO Standing Committee No. 1

ATTACHMENT

Additional Detailed Comments

Introduction

In our comment letter on clarity, we reflected on the unclear status of some paragraphs in the Introduction section. Our comments also apply to paragraphs 2-4 of this ED.

Definitions

It is important that, as definitions are introduced in a standard, the glossary of definitions is also concurrently updated.

Example of definitions

We suggest that footnote 1 in paragraph 10, which refers to examples of definitions of “control” and “significant influence”, could be amended to refer to the definitions under applicable financial reporting framework, if applicable.

Explanatory material included in the requirements section

Further to our comment letter on clarity, we suggest that the following paragraphs or parts of paragraphs should be moved from the requirements section to the application material section as they do not impose or provide essential explanation for requirements.

- First sentence of paragraph 11
- Paragraph 18

Use of ‘shall consider’

Paragraphs 12 and 20 include the phrase ‘shall consider’. It is not always clear what is expected of the auditor when this verb is used. Particularly in paragraph 12, the verb ‘evaluate’ would seem more appropriate. In this paragraph it should also be made clearer why the auditor is considering this area and what the auditor is then expected to do when they have identified a previously unidentified or undisclosed related party transaction.

Additional points to be added in related application material

Paragraph A7:

- Transactions which have unusual terms of trade such as unusual prices, interest rates, guarantees or repayment terms
- Transactions which seem to lack a logical or business reason for occurrence
- Special purpose entities

Paragraph A 10:

- Overly complex transactions involving multiple entities within a group of companies
- Transactions which cover unconsolidated parties including special purpose entities
- Whether the transactions involve previously unidentified related parties or parties that do not have the substance or financial strength to support the transaction without assistance from the entity under audit
- Consolidated parties, where consolidation is not appropriate.

There could also usefully be some inclusion in paragraph 11 of further cross-references to ISA 315 regarding the use of other work and in paragraphs 11 and 13 to ISA 600 regarding enquiry of and sharing information with other auditors in the group.

Ordering of requirements

We are not convinced that the ordering of the requirements reflects the appropriate order in which they would occur in an audit. For example, paragraph 13 covers the sharing of related party information amongst the engagement team. However, this is placed before the discussion of understanding the business rationale for related party transactions and the control environment (Paragraphs 15 & 16). We believe it is important that all the information in paragraphs 15 & 16 should be shared with the engagement team as laid out in paragraph 13.

Requirements – business rationale

Paragraph 15 Understanding the business rationale is not the only issue with related party transactions. The transactions may also be illegal and therefore could lead to material misstatements of the annual accounts. Thus auditors should evaluate the impact of such transactions on local laws and regulations e.g. re tax avoidance versus tax evasion..

Paragraph 22 We are not sure that the phrase 'having particular regard to their business rationale' is very clear, and there is no further guidance in the application material.

Application material – other points

- A 2 The emphasis is on the formal definition of control or significant influence. It would be more helpful to change the emphasis to recognise that such control or significant influence is not always evidenced by ownership or voting power.
- A10 The example given is not sufficiently clear in making the point of the paragraph. For example, a transfer price arrangement, assuming it is disclosed, would not necessarily result in a misstatement.
- A20 We believe the term "where practicable" should be deleted from the second bullet. The practicality of matters is broadly applicable to all guidance in the application material and we are not clear why this was singled out.
- A27 We believe you would also want to evaluate whether the relationships and transactions have been fairly stated.