

Revision of ISA 550 “Related Parties” – Issues Paper

Introduction

OBJECTIVES

1. The objectives of this project are to update and strengthen ISA 550 to address the audit of related party (RP) relationships and related party transactions (RPTs).

The need to revise ISA 550 arises mainly for the following reasons:

- The prominent role played by RPs in a number of recent major corporate scandals and the structuring of RPTs and complex off-balance sheet arrangements designed to avoid recognition or disclosure of the effect of common control relationships.
- Growing public sentiment that demands stronger standards addressing the understandability and adequacy of RP disclosures.¹
- The support for a risk-based approach to the audit of RP relationships and RPTs based on the new audit risk standards and academic research.²
- The need to revisit ISA 550 since it was originally issued in 1984 (recodified with no substantive changes in 1994) to ensure that it continues to provide robust and appropriate requirements and guidance for today’s audits, bearing in mind revisions that have been made to a number of national RP auditing standards since then.

LESSONS FROM THE ENRON AND MAXWELL CASES

2. Many reports and articles have been written regarding the causes and circumstances of Enron’s collapse in the United States towards the end of 2001. Whilst a definitive report may yet have to be written, the task force found it helpful to study the Report of the Investigation by the Special Investigative Committee of the Board of Directors of Enron Corp (the Enron Report) issued in February 2002 that highlighted a number of significant issues with Enron’s RP disclosures. This Issues Paper includes a discussion of these significant issues.
3. In addition, the task force reviewed the research paper “Improving the Auditing of Entities Subject to Common Control” (the APB Paper) that the UK Auditing Practices Board issued in October 2003 and that drew from the lessons learned from the collapse of the Maxwell group of companies in the UK in 1991. This Issues Paper includes a discussion of the recommendations of the APB Paper that are relevant to the revision of ISA 550.

¹ The Journal of Accountancy, for example, reported in its April 2002 issue: “Douglas Carmichael, the Wollman Distinguished Professor of Accounting at Baruch College in New York City, told the Wall Street Journal in November 2001 that most people would be hard pressed to understand the effect of Enron’s disclosures on the financial statements, casting doubt on both the quality of the company’s earnings as well as the business purpose of the transactions. ... A number of analysts questioned the lack of transparency of Enron’s disclosures. One analyst was quoted as saying, *‘The notes just don’t make sense, and we read notes for a living.’*”

² See for example, “Why do Audits Fail? Evidence from Lincoln Savings and Loan” (Erickson, Mayhew and Felix, Journal of Accounting Research, Vol 38, No. 1, Spring 2000).

COORDINATION WITH THE INTERNATIONAL ACCOUNTING STANDARDS BOARD

4. The requirements of the applicable financial reporting framework (FRF) are an essential consideration because these establish the extent of management's responsibilities in relation to the identification, accounting for and disclosure of RP relationships and transactions. Accordingly, although this project is concerned with strengthening auditors' responsibilities in this area, it is important to recognize that the applicable FRF "sets the tone" for what is required and that management has a major role to play in fulfilling its responsibilities.
5. ISA 550 adopts the RP definitions in IAS 24, "Related Party Disclosures." In view of this inter-relationship between ISA 550 and IAS 24 and the existence of certain issues that appear common to the two Standards, IAASB Chairman John Kellas wrote to the IASB on behalf of the task force in June 2004 to request, inter alia, that the IASB appoints an appropriate representative to work closely with the task force as the latter deliberates the issues and prepares its recommendations. The task force believes that such coordination is important in addressing all significant common issues and minimizing inconsistencies between ISA 550 and IAS 24.

INPUT FROM THE IAASB'S CONSULTATIVE ADVISORY GROUP

6. The IAASB's CAG met in June 2004 and had a preliminary discussion of certain of the more significant issues that this project will address. The CAG's initial views pertaining to these issues are discussed in the appropriate sections of this Issues Paper.

Key Issues

7. The task force has identified the following key issues for consideration by the IAASB:
 - The scope of ISA 550
 - Adopting a definition of "related party"
 - Addressing perceived shortcomings in the FRF
 - Transactions between parties that are "almost related"
 - Changing to a risk-based approach
 - Eliminating the defensive stance in ISA 550
 - Understanding the entity
 - The risk assessment process
 - Responding to assessed risk
 - Understandability of RP disclosures
 - Defining the standard of understandability
 - The role of materiality and conflicts of interest
 - Substantiation of arm's length transactions
 - Estimating an imputed value for a related party transaction with no recorded value

The Scope of ISA 550

ADOPTING A DEFINITION OF “RELATED PARTY”

8. Paragraph 1 of extant ISA 550 states that the ISA applies regardless of whether IAS 24 is part of the FRF. This rightly makes the ISA framework-neutral from an accounting perspective, consistent with the IAASB’s philosophy of issuing auditing standards that are framework-neutral. Paragraph 4 of the ISA, however, states:

“Definitions regarding related parties are given in IAS 24 and are adopted for the purposes of this ISA.”

9. In the task force’s view, this creates an ambiguity in that it would appear to impose an override over other (different) definitions that might be adopted for the same terms in applicable FRFs. The issue crystallizes particularly in relation to interpreting the requirement in paragraph 8 of the extant ISA:

“Where the financial reporting framework requires disclosure of related party relationships, the auditor should be satisfied that the disclosure is adequate.”

Aside from the issue of resolving potential conflicts between two different sets of definitions, disclosures based on non-IFRS FRFs might be viewed as inadequate where they hinge upon definitions that are weaker or less comprehensive than the benchmark IAS 24 definitions adopted in this ISA.

10. This issue derives in part from the wider issue (discussed next) of whether and if so how the auditor should address perceived shortcomings in the applicable FRF. In this instance, however, the task force believes that it remains appropriate to use definitions of accounting terms that are set out in IASs/IFRSs as a baseline. The interpretation issue discussed above might then be resolved by clarifying that the adoption of IAS 24 definitions in the ISA does not imply an intention for IAS 24 to override the disclosure requirements of the applicable FRF or national law or regulation, although the auditor would have a continuing responsibility to ensure that the disclosures are not misleading.

Action Required by IAASB

Does the IAASB agree that it remains appropriate to adopt the IAS 24 definition of “related party” and definitions of related terms (i.e. “related party transaction,” “close members of the family,” “control,” “joint control,” “key management personnel,” and “significant influence”) (see Appendix) for the purposes of ISA 550?

Does the IAASB agree that it is necessary to clarify that although IAS 24 definitions are adopted in the ISA, it is not intended that IAS 24 requirements should override the disclosure requirements of the applicable FRF or national law or regulation, although the auditor would still need to be satisfied that these disclosures are adequate and not misleading?

ADDRESSING PERCEIVED SHORTCOMINGS IN THE FINANCIAL REPORTING FRAMEWORK

11. The task force debated whether the auditor should address perceived shortcomings in the applicable FRF (if it is not IAS/IFRS) when IAS 24 provides more stringent or comprehensive requirements. Specifically, the task force questioned whether the auditor should follow the requirements and guidance in IAS 24 if the applicable FRF does not address all the RP disclosures required by IAS 24

(i.e. an accounting override). Such a situation occurs in some jurisdictions such as France where, in respect of non-consolidated financial statements, the FRF does not address all the RP disclosures that would be required under IAS 24.

12. Recognizing that this is an issue that extends beyond related parties, the task force believes that the key principle is that the auditor should not be associated with misleading financial statements. Accordingly, the task force believes that where the applicable FRF falls clearly short of what would be necessary to achieve fair presentation, the auditor should be encouraged to follow the principles in IAS 24. The application of such a principle would effectively amount to an accounting override that should be done only for material RPTs.
13. CAG members did not express any consensus view on this issue but noted that the issue was related to the much broader question of how the auditor should report on financial statements that have been prepared in accordance with a FRF that does not have all the characteristics of good generally accepted accounting principles.

Action Required by IAASB

What are the IAASB's views regarding whether and, if so, how the auditor should address perceived shortcomings in the applicable FRF?

If the auditor should apply an accounting override, would it be appropriate for the auditor to use the requirements of IAS/IFRS as a benchmark?

If disclosures are to be audited for adequacy beyond what is strictly required by the applicable FRF, how should "adequacy" be defined? (See also the issue of understandability at paragraphs 44-50 below).

Does the IAASB agree that ISA 550 should encourage the auditor to apply the principles in IAS 24 if the applicable FRF clearly would result in misleading or inadequate disclosures?

TRANSACTIONS BETWEEN PARTIES THAT ARE "ALMOST RELATED"

14. The premise in IAS 24 in justifying the requirement to disclose RPTs is that RPs are presumed to be able to negotiate material transactions on terms that would not be available from clearly independent third parties. As IAS 24 asserts, such disclosure is important because knowledge of these transactions may affect assessments of an entity's operations, risks and opportunities by users of financial statements.
15. The task force discussed whether indeed only RPTs should be presumed to be conducted on non-arm's length terms, or whether the auditor should also have regard to transactions between the entity and other parties (not falling within the definition of RPs) with whom the entity has a relationship that enables the entity to negotiate terms that may not be available from other, more clearly independent third parties. There is a school of thought³ that the disclosure of such transactions should be equally important to users of financial statements because, like RPTs, they are conducted on terms that may be more or less favorable than those available at arm's length, and users would not have a complete

³ The U.S. SEC, through Release Nos. 33-8056, 34-45321 and FR-61 addressing Item 303 of Regulation S-K, "Management's Discussion and Analysis of Financial Condition and Results of Operations," effectively requires U.S.-listed entities to disclose in the MD&A non-arm's length transactions with parties that do not fall within the definition of "related parties."

understanding of the entity's financial position, results and cash flows without clear disclosures of these relationships and transactions.

16. Examples of such “almost related” parties include:

- Entities that may be operated by individuals who were formerly part of the entity's senior management or who have some current or former relationship with the entity.
- Entities that are entirely dependent upon one or two customers for all or most of their business so that transactions with these customers may no longer be conducted on arm's length basis.
- Entities that, because they were formerly part of the same group, maintain close commercial relationship with the reporting entity without the exercise of control or significant influence and are able to negotiate transaction terms on non-arm's length basis.

17. The task force considered whether the scope of the auditor's responsibilities should be enlarged to include auditing the disclosure of such relationships and transactions. The task force concluded that this issue should not be addressed in this project because, first and foremost, it is an accounting issue. Secondly, expanding the scope in this way could have far-reaching implications, such as requiring the disclosure of transactions with an “almost related” party of a related party. Thirdly, there is a lack of an accepted accounting definition for parties that are “almost related,” and agreeing on a definition would be a difficult task by itself given the fuzziness of the relationships involved and the subjectivity in interpreting these relationships. Finally, there would be practical difficulties for the reporting entity itself in obtaining and recording information from parties it might not know or have access to.

18. In sum, the task force does not believe it would be appropriate at this time to expand the scope of the ISA to address relationships and transactions with parties that are “almost related.”

Action Required by IAASB

Does the IAASB agree that the scope of the ISA should not be expanded to address the auditing of relationships and transactions with parties that are “almost related?”

Changing to a Risk-based Approach

ELIMINATING THE DEFENSIVE STANCE IN ISA 550

19. The present ISA 550 is procedures-driven and does not take a risk-based approach to the audit of RP relationships and transactions. It states that:

“Because of the degree of uncertainty associated with the financial statement assertions regarding the completeness of related parties, the procedures identified in this ISA will provide sufficient appropriate audit evidence regarding those assertions in the absence of any circumstance identified by the auditor that:

- (a) Increases the risk of misstatement beyond that which would ordinarily be expected; or
- (b) Indicates that a material misstatement regarding related parties has occurred.

Where there is any indication that such circumstances exist, the auditor should perform modified, extended or additional procedures as are appropriate in the circumstances.”

20. The APB Paper recognized that, through the above statement, the ISA appears to provide the auditor with a ready justification (and motivation) to follow a routine compliance approach in the absence of “unusual circumstances” identified by the auditor. The APB Paper further noted that it is doubtful that the tone of the statement would engender a sufficiently skeptical attitude on the auditor’s part and active consideration of the existence and effect of RPs.
21. The task force agrees that limiting the auditing of RP relationships and transactions to specific procedures only in the absence of unusual circumstances may no longer be sufficient and acceptable in the current environment where the auditor is increasingly expected to be more proactive in searching for undisclosed RPs and RPTs and any potential associated fraud. Consequently, the task force believes that the ISA should not limit the auditor to pre-determined audit procedures but direct the auditor to an approach based upon identification and assessment of risks.
22. In addition, whilst it would be inappropriate for the ISA to take an overly defensive position, the task force believes it would still be important for the ISA to give recognition to the inherent difficulties in detecting RPs and RPTs so as not to raise the expectation bar unrealistically high. CAG members agreed with this but expressed the view that the concept of “inherent limitations” should be described in a positive manner, perhaps focusing on the reasonable assurance that the auditor could obtain when auditing RP relationships and transactions. The task force believes that the recently issued fraud ISA may provide an appropriate model to follow in terms of finding an appropriate balance between acknowledging the inherent difficulties of detection and requiring the auditor to adopt a positive approach to detection.
23. CAG members also expressed the view that it was important to retain a balance between adopting a risk-based approach and requiring the auditor to perform specific audit procedures to identify RPs and RPTs. CAG indicated it would be particularly concerned if all the procedures⁴ in the extant ISA were eliminated in favor of a risk-based approach and accordingly expressed support for a minimum set of procedures. The task force noted these comments and believes that the adoption of a risk-based approach will not obviate the need for the auditor to perform specific substantive audit procedures in all cases, for example, making appropriate inquiries of management. In addition, an elevated risk assessment should prompt the auditor to increase the scope of substantive procedures to identify and understand the nature of RPTs and to ensure proper accounting and disclosure for such transactions.

Action Required by IAASB

Because of the higher risk of material misstatement, the APB Paper recommends that the auditor adopts a high degree of skepticism in auditing RPs and RPTs and that the auditor should proactively consider the risks associated with RPTs. Does the IAASB agree with this

⁴ For example, paragraph 7 of the extant ISA requires the auditor to, amongst other things, review prior year working papers for names of known RPs, review minutes of the meetings of shareholders and the board of directors, and inquire as to the affiliation of directors and officers with other entities.

recommendation?

Does the IAASB agree that it would be appropriate to follow the approach taken by the fraud ISA in relation to explaining the inherent difficulties of detection?

Does the IAASB agree that the auditor should be required to perform certain specific substantive procedures in all cases, over and above procedures that may be designed in response to assessed risk?

UNDERSTANDING THE ENTITY

24. The present ISA states:

“The auditor needs to have a level of knowledge of the entity’s business and industry that will enable identification of the events, transactions and practices that may have a material effect on the financial statements.”

25. As the APB Paper notes, this does not specifically address the importance of understanding the nature and extent of any relationships between the entity and its RPs. Understanding the RP relationship, whether it is through control or significant influence or as otherwise defined by the applicable FRF, is important because such relationship prevents the entity from having independent discretionary powers over its resources and transactions and its ability to pursue its activities independently.

26. The task force believes that the ISA should establish specific requirements and guidance for the auditor to understand the relationships between the entity and its owners and other individuals and entities with which it deals with. These requirements and guidance would reinforce the guidance in paragraph 27 of ISA 315, “Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement,” which states that such an understanding is important in determining whether RPTs have been identified and accounted for appropriately.

Action Required by IAASB

Does the IAASB agree that the ISA should have a stronger requirement for the auditor to specifically understand the relationships between the entity and its owners and other individuals and entities with which it deals with?

THE RISK ASSESSMENT PROCESS

Consideration of Risk Factors

27. ISA 550 does not presently give due consideration to risk factors that should be taken into account in the risk assessment process. It focuses instead, at paragraph 11, on the need to maintain a general alertness during the audit and provides some examples of transactions that the auditor might come across that could raise a red flag.

28. The task force believes that this does not sufficiently emphasize the importance of having a thorough risk assessment process to help the auditor identify risks and design more probing procedures where warranted. In the task force’s view, the ISA should include more robust requirements and guidance

focused on consideration of specific identified risk factors to assist the auditor in the risk assessment process.

29. Also, given the major fraud cases that involved RPTs such as Parmalat in Italy, Adelphia Communications in the US, and Maxwell Communications in the UK, the task force believes that the auditor should devote attention to the assessment of the risk of manipulation or deliberate concealment of RPs and RPTs for fraudulent or other purposes. Such a risk is higher particularly in entities with overly complex group or transaction structures, entities controlled by a common party that are not required to be consolidated (i.e. horizontal groups or “business empires”), and entities dominated by a single individual.
30. The task force believes it would be useful to consider the approach taken in the recently-issued fraud ISA with regard to the risk assessment process since that ISA also deals with the common issue of detection. The task force also believes that it would be helpful guidance to provide the auditor with a non-exhaustive list of common RP risk factors to consider.

Action Required by IAASB

Does the IAASB agree that the ISA should require the auditor to specifically consider factors that may increase the risk of material misstatement regarding the identification and disclosure of RP relationships and transactions?

Does the IAASB agree that it would be appropriate to provide a non-exhaustive list of RP risk factors for the auditor to consider in the risk assessment process?

Evaluation of Internal Controls

31. The APB Paper notes that ISA 550 presently only requires the auditor to consider the adequacy of control procedures over the authorization and recording of RPTs. The APB Paper notes further that this is a risk assessment procedure that is not subsequently developed within the ISA to require the auditor to:
 - (a) Develop an expectation concerning the likely effectiveness of internal control over RPTs; and
 - (b) Test the effective operation of internal control where such control is likely to be effective.
32. In the Enron case, the Enron Report noted the following significant internal control issues relating to RPTs:

“...it appears that no one outside of Enron Global Finance, the entity principally responsible for the RPTs, exercised significant supervision or control over the disclosure process concerning these transactions.”

“Enron’s in-house counsel say they relied on advice from [the outside lawyers] in deciding whether the proposed disclosures were adequate with respect to RPTs. ...We were told that members of the Board focused particular attention to the disclosures about themselves, and were not directed specifically to the RPT disclosures by management.”

“There was no systematic procedure in place for ensuring identification of all transactions with RPs that needed to be disclosed in the financial statement footnotes or proxy statements.”

“It appears, however, that none of the persons [i.e. Enron’s Audit and Compliance Committee] independent of the Enron officers and employees responsible for the transactions provided forceful or effective oversight of the disclosure process.”

33. The APB Paper argues, and the task force agrees, that the ISA would be strengthened if the auditor were specifically required to:
- (a) Understand and evaluate the design of the entity’s controls over the identification and recording of RPs and RPTs, including ascertaining responsibilities within the entity for RP disclosures;
 - (b) Determine whether these controls have been implemented; and
 - (c) Consider testing the controls where there is a reasonable expectation that such controls are likely to be effective.

Action Required by IAASB

Does the IAASB agree that the ISA should include greater requirements for the auditor to understand and evaluate the design of internal control with respect to RPs and RPTs, and to consider testing internal control where likely to be effective?

RESPONDING TO ASSESSED RISK*Obtaining Evidence from Interested Parties*

34. ISA 550.14 presently states that because of the limited availability of appropriate audit evidence regarding certain types of RPTs (e.g. those that do not involve exchange of consideration), the auditor would consider confirming or discussing information with the RPs or other persons associated with the transactions (“interested parties”).
35. The APB Paper recommends that the auditor should be encouraged to seek evidence of the purpose of transactions from such interested parties in those circumstances where the transactions appear to lack commercial logic. More specifically, it recommends developing and extending the guidance in ISA 550 to:
- Explain more clearly the purpose of seeking evidence from others; and
 - Recommend that the auditor only accept terms of engagement that permit the auditor access to those from whom he wishes to obtain audit evidence.
36. The task force agrees with this recommendation but notes that because RPTs are often characterized by a lack of audit trail, the auditor should not only be encouraged but required to consider obtaining evidence from interested parties where warranted. This would not only provide an appropriate response for the auditor in dealing with a higher risk situation where audit evidence is insufficient or lacking, but also instill a greater responsibility on the auditor to be more proactive in searching for

audit evidence. The task force agrees that to enable the auditor to have unfettered access to those parties the auditor considers it is appropriate to contact, the auditor should only accept terms of engagement where the entity grants permission to the auditor to access relevant interested parties. A conforming change to ISA 210, “Terms of Audit Engagements,” may be appropriate in this regard.

37. The imposition of a requirement on the auditor to consider obtaining evidence from interested parties should, however, be balanced against the limitations inherent in the approach, i.e.:
- Not all interested parties may reply or be willing to discuss RP relationships and transactions with the auditor because of business confidentiality, fear of potential commercial liability, or other reasons; and
 - Some RPs may be subject to significant influence from management and, as a result, evidence from such parties may be less reliable.

Action Required by IAASB

Although there are inherent limitations in this approach, does the IAASB agree that there should be a greater responsibility on the auditor to consider obtaining audit evidence from interested parties where warranted by the risk assessment?

Obtaining Representations from Key Parties within the Entity

38. The extant ISA 550 requires the auditor to obtain written representation from management concerning the completeness of RP information provided and the adequacy of RP disclosures in the financial statements. The APB Paper notes, however, that in view of the inherent difficulties of detecting undisclosed RPTs, the auditor should be encouraged to consider seeking representations directly from the audit committee (or equivalent), other directors and relevant members of management.
39. The task force agrees that the difficulties of detection of RPTs warrant broadening the scope of individuals from whom representations could be obtained. In addition to management, consideration should be given to obtaining representations from the audit committee (or equivalent), other directors and key officers within the entity other than management. The task force recognizes that this issue may also be addressed by the Representations task force, which is currently working on a revision of ISA 580, “Management Representations.” The task force will liaise with the ISA 580 task force so that the issue is addressed consistently.
40. The identification of parties from whom the auditor should obtain representations should be driven primarily by the results of the auditor’s risk assessment process. In addition, the task force believes that representations that the auditor obtains should address specific RP issues where appropriate, for example, the existence of side agreements on significant RPTs.

Action Required by IAASB

Does the IAASB agree that the scope of representations should be broadened to include the audit committee (or equivalent), other directors, and key officers other than management where justified by the auditor’s risk assessment process?

Communicating with those Charged with Governance

41. ISA 550 is presently silent on whether the auditor should report to and discuss any RPT issues with those charged with governance. The Enron Report highlighted this as a significant shortcoming in the case of Andersen:

“An internal Andersen e-mail from February 2001 released in connection with recent Congressional hearings suggests that Andersen may have had concerns about the disclosures of the RPTs in the financial statement footnotes. Andersen did not express such concerns to the Board.”

42. Other recent accounting scandals such as Worldcom, Adelphia and Tyco also highlighted significant audit shortcomings in that material RPTs involving management were not appropriately scrutinized, examined with those charged with governance, and disclosed.
43. In view of this, the task force believes that the auditor should have a greater responsibility to communicate with those charged with governance regarding the completeness, substance, propriety and disclosure of significant RPTs. Such communication would also provide an opportunity for the auditor to corroborate responses from management in respect of inquiries the auditor made regarding the completeness of RPTs.

Action Required by IAASB

Does the IAASB agree that the auditor should have a greater responsibility to communicate with those charged with governance regarding the completeness, substance, propriety and disclosure of significant RPTs?

Understandability of Related Party Disclosures

DEFINING THE STANDARD OF UNDERSTANDABILITY

44. The basic principle in the extant ISA 550 regarding understandability requires that “[w]here the financial reporting framework requires disclosure of RP relationships, the auditor should be satisfied that the disclosure is adequate.” There is, however, no guidance in the ISA elaborating on this principle, and in particular, what is meant by “adequate.”
45. IAS 24.17 is also short on guidance, other than providing the following high level principle:
- “If there have been transactions between related parties, an entity shall disclose the nature of the related party relationship as well as information about the transactions and outstanding balances necessary for an understanding of the potential effect of the relationship on the financial statements.” [Emphasis added].
46. The issue as to what is the standard of understandability or adequacy for RP disclosures appears in fact pervasive across the accounting profession. The Enron Report noted, in particular:
- “Following the original release of FAS 57, public companies and their professional advisors and auditors have received little guidance from the accounting profession or the SEC on how these standards should be applied to disclosures of particular types of

transactions. ...Indeed, in light of the Enron experience, the Big-5 accounting firms petitioned the SEC on December 31, 2001, for guidance in preparing disclosures in annual reports in several areas, including *'relationships and transactions on terms that would not be available from clearly independent third parties.'*”

47. The Enron Report also highlighted a number of specific issues regarding the understandability of Enron's RPT disclosures, including:
- **Disclosure of the business purpose of the RPT:** “Enron...never clearly disclosed the purposes behind these transactions;”
 - **Disclosure of the economic substance of the RPT:** “Enron failed to disclose facts that were important for an understanding of the substance of the transactions;”
 - **Disclosure of the identity of the RPs:** “The footnote did not identify Fastow as the senior officer of Enron. ... From the second quarter of 2000 forward, Enron did not identify LJM1 and LJM2 by name in the financial statement disclosures, using the generic term ‘Related Party’ instead.”
 - **Adherence to the letter but not the spirit of the law:** “The lawyers apparently searched for and embraced a technical rationale to avoid that disclosure.”
 - **Disclosure of the financial statement effects of the RPT:** “Enron ... never clearly disclosed the complete financial statement effects of these complex arrangements;”
 - **Disclosure of the nature and extent of involvement of management in the RPT:** “Enron did not set forth the CFO's actual or likely economic benefits from these transactions. ... The proxy statement did not give the amount of compensation the CFO had received, or specify the compensation formula in any detail. ... In-house and outside counsel [justified the non-disclosure of the CFO's compensation on the basis that] it was not ‘practicable’ to determine what the CFO had earned as the managing member of the RP;” and
 - **Disclosure of risks and contingencies of the RPT:** “The footnotes also glossed over issues concerning the potential risks and returns of the transactions, their business purpose, accounting policies implicated, and contingencies involved.”
48. In the task force's view, the primary responsibility for setting requirements and providing guidance on the standard of understandability rests with the accounting framework. Specifically, disclosures should describe elements of the RPTs necessary for a competent user of the financial statements to clearly understand:
- The business purpose of the transactions;
 - The economic substance of the transactions;
 - The names of the RPs, where appropriate;
 - The effects of the transactions on the financial statements;
 - Where management is participating in the RPTs, the nature and extent of its involvement, including any compensation or rewards (monetary or in-kind) that management stands to gain, regardless of whether such compensation or rewards are contingent on future events or can only be estimated;

- Any special risks or contingencies arising from the RPTs; and
- Any other facts critical to a fair assessment of the RPTs.

49. The task force believes that IAS 24 falls short in this respect and, as indicated in the introduction to this Issues Paper, IAASB Chairman John Kellas has written to the IASB on behalf of the task force in June 2004 to request that the IASB address the specific issue of understandability (particularly what the term “information” means in IAS 24.17) at the earliest opportunity, and appoint an appropriate representative to work closely with the task force.
50. Although the task force believes that the IAASB should not address what the task force views as essentially an accounting issue (i.e. defining the standard of understandability), it nonetheless believes that ISA 550 should provide guidance on how the auditor satisfies himself that RPT disclosures are adequate. Such guidance could be in terms of, for example, evaluating the quality, clarity and substance of the disclosures in relation to the requirements of the applicable FRF.

Action Required by IAASB

Does the IAASB agree that the ISA should not address the elements necessary for RPT disclosures to be understandable?

Does the IAASB agree that the ISA should nonetheless provide explanatory guidance to assist the auditor in evaluating the adequacy of RPT disclosures?

THE ROLE OF MATERIALITY AND CONFLICTS OF INTEREST

51. The task force believes that the determination of whether a RPT should be disclosed should be based primarily on whether the RPT is material to the entity, as opposed to whether it is material (measured either in quantitative or qualitative terms) to the RP, not least because of the practical difficulties in determining what is material to RPs in all cases.
52. The Enron Report noted, however, the following in respect of the inadequate disclosure of Enron’s material RPTs with management:
- “The amount of the CFO’s interest [in the RPT] should have weighed in the disclosure decision.”
53. In the view of the task force, it is not so much the materiality of the RPT to the RP that should determine whether disclosure is necessary but whether the RP is involved in a potential conflict of interest. As a report on Enron from the AEI-Brookings Joint Center for Regulatory Studies⁵ noted:
- “Most prospective investors realize that once they have committed their funds to a corporation, either by purchasing shares directly or from a shareholder, they will have little control over how the corporation is managed. Consequently, they usually are interested in how those who do have control use corporate resources, and the extent to

⁵ Following the Money – The Enron Failure and the State of Corporate Disclosure (George Benston, Michael Bromwich, Robert E. Litan & Alfred Wagenhofer, AEI-Brookings Joint Center for Regulatory Studies, 2003).

which controlling persons (including senior managers) have *conflicts of interest* that might result in costs being imposed on non-controlling shareholders.”

This report came to the following conclusion regarding the collapse of Enron:

“One of Enron’s major failings was inadequate reporting of and accounting for a conflict of interest accepted by its board of directors.”

Action Required by IAASB

Does the IAASB agree that a critical factor in determining the need for disclosure of RPTs is whether the RPs have potential conflicts of interest vis-à-vis the interests of the entity’s shareholders?

Does the IAASB agree that this is an accounting issue and, as a result, should not be addressed in the ISA?

SUBSTANTIATION OF ARM’S LENGTH TRANSACTIONS

54. Entities frequently make representations in their disclosures that RPTs were conducted on arm’s length basis, principally, as the Enron Report noted, “*to reassure investors that the transactions were fair to the entities and the entities’ shareholders.*” IAS 24.21 in fact states that “[d]isclosures that RPTs were made on terms equivalent to those that prevail in arm’s length transactions are made only if such terms can be substantiated.”

55. The Enron Report highlighted the following regarding Enron’s disclosures:

“The disclosures also asserted without adequate foundation, in effect, that the arrangements were comparable to arm’s-length transactions. ... We have not been able to identify any steps taken by management or the auditors to substantiate the assertions that the RPTs were ‘representative of’ or ‘reasonable compared to’ similar transactions with unrelated parties.”

56. ISA 550 is effectively silent on the issue of substantiation. The task force believes that the potential for users of financial statements to be misled by disclosures asserting that RPTs have been conducted on arm’s length basis is sufficiently great that ISA 550 should place a clear responsibility on the auditor to audit the basis of such disclosures. Specifically, the ISA should:

- (a) Make it clear that the auditor should not to agree to such disclosures without substantiation;
- (b) State that the responsibility for substantiation rests with management; and
- (c) Require the auditor to verify the evidence provided by management to substantiate the arm’s length basis of the RPT before permitting disclosure on that basis.

Action Required by IAASB

Does the IAASB agree that the ISA should provide specific requirements and guidance for the auditor to audit the basis of disclosures asserting that RPTs have been conducted on arm’s length basis?

Estimating an Imputed Value for a Related Party Transaction with no Recorded Value

57. A specific issue that the task force considered was whether it would be appropriate for the auditor to require the entity to estimate or place an imputed value on RPTs with no recorded values, or which management asserts to be “immaterial,” to determine the impact of these transactions on the financial statements.
58. In the task force’s view, this is a measurement issue that should be dealt with by the FRF. The task force thus believes that it would not be appropriate for the ISA to deal with estimation of values for RPTs.

Action Required by IAASB

Does the IAASB agree that the estimation of values for RPTs with no recorded values is essentially an accounting issue and, as a result, should not be addressed in the ISA?

APPENDIX

The IASB has adopted the following related party definitions in the revised IAS 24 issued in December 2003:

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.

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