

29 June 2007

Mr Jim Sylph
Executive Director, Professional Standards
International Auditing and Assurance Standards Board
International Federation of Accountants
545 Fifth Avenue, 14th Floor
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USA



THE INSTITUTE
OF CHARTERED
ACCOUNTANTS
IN ENGLAND AND WALES

By email

Our ref: ICAEW Rep 56/07

Dear Mr Sylph

Proposed Revised and Redrafted ISA 550 Related Parties

The Institute of Chartered Accountants in England and Wales (the Institute) welcomes the opportunity to comment on Proposed Revised and Redrafted ISA 550 published by IAASB in February 2007.

The Institute operates under a Royal Charter, working in the public interest. Its regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the Financial Reporting Council. As a world leading professional accountancy body, the Institute provides leadership and practical support to over 128,000 members in more than 140 countries, working with governments, regulators and industry in order to ensure the highest standards are maintained. The Institute is a founding member of the Global Accounting Alliance with over 700,000 members worldwide.

We believe that the clarification reformatting has resulted in a more readable and user-friendly document than previous versions. However, changes to the requirements and definitions will help ensure consistency of interpretation and improved audit quality, as explained below.

We particularly welcome the demarcation between this ISA and the fraud ISA, the logical division between risk assessment and response to risk, the recognition that most related party transactions are routine and not high risk, and the acknowledgment of inherent limitations in the auditor's ability to detect material misstatements in the context of related parties.

Please contact me should you wish to discuss any of the points raised in this response.

Yours sincerely

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Question 1: Is the proposed definition of a related party appropriate?

The proposed definition of a related party is not inappropriate but we remain concerned, as noted in our letter to IAASB on the previous exposure of ISA 550, about attempts to compensate for perceived inadequacies in applicable financial reporting frameworks through auditing standards. Experience shows that attempts by ISAs to establish requirements for management have been unsuccessful and the proposed definition of related parties is in the unhappy position of being neither the same as the proposed IAS 24 definition, nor different to it. Some jurisdictions will interpret the definition in the context of proposed IAS 24, others will not.

We also remain concerned that there may be wide variations in what are deemed to be frameworks with 'minimal or no' related party requirements, particularly in the context of the requirements regarding compliance frameworks. The standard requires auditors to assess whether information relating to related parties in compliance frameworks is 'misleading' which may be challenging for auditors operating in jurisdictions in which only non-compliance is generally accepted to be misleading.

IAASB should continue its dialogue with standard-setters in this and similar areas and should monitor the post-implementation application of this ISA particularly carefully.

Question 2: Should the ISA address the auditing implications of implicit arm's length assertions? If so, what should the approach be, bearing in mind the need to distinguish between explicit and implicit assertions?

The ISA should address the auditing implications of implicit arm's length assertions

ISAs should not deal with jurisdiction-specific issues. However, where issues arise in a number of jurisdictions they cease to be jurisdiction-specific. Auditors are required to deal with implicit arm's length assertions under the financial reporting frameworks more than one major jurisdiction and IAASB should therefore address the issue, particularly in the light of the fact that the European Union will be added to the list of such jurisdictions.

In principle, there should be little difference between the audit of explicit and implicit assertions and there may be no need to distinguish between them. In both cases, the assertion is difficult to substantiate where the transactions with the related party are unique or nearly unique and there are no clearly arm's length transactions with which to compare them. In both cases auditing for completeness is a major issue but for implicit assertions audit scope is wider. The audit approach to implicit assertions would focus on substantiating completeness by ascertaining, on the basis of risk, which if any of all the transactions not explicitly disclosed as not at arm's length, should have been so disclosed. Guidance in this area need not be extensive but it should focus on the extent and nature of the additional audit work expected, taking account of the adequacy of controls and previous experience with the client where relevant. Additional written representations would be required of management and further work might include inspection of the terms of business for transactions at risk and direct confirmations from the related party.

Other Matters

1. Arm's length assertions as significant risks

Not all assertions that related party transactions are conducted on terms equivalent to arm's length give rise to significant risks. The second bullet of paragraph 21 should be deleted. If it is retained, it needs to be restated to clarify whether or not it applies to explicit and/or implicit arm's length transactions.

Paragraph 21, second bullet, requires the auditor to treat a management assertion that a related party transaction has been conducted on terms equivalent to arm's length as a circumstance giving rise to significant risk. This is inconsistent with paragraph 2 which states that many related party transactions in the normal course of business carry no higher risk of material misstatement than similar transactions with unrelated parties. The second bullet of paragraph 21 should be deleted or modified.

2. Paragraph 7

We note above our approval of the recognition in paragraph 7 of the inherent limitations of the audit of related party transactions. This paragraph would be further improved by recognising that whilst the auditor will obtain reasonable assurance on related party transactions, the level of assurance obtained is likely to be lower than that obtained for other assertions. We have recently made a similar point with regard to the level of assurance that can be obtained on the going concern assumption in our response to IAASB on its exposure of ISA 570.

3. Paragraph 10

A more logical ordering of the objective in paragraph 10 would start with (b) (i) obtaining an understanding, followed by (b) (ii) fraud risk followed by (a) accounting and disclosure.

4. Paragraph 16

Paragraph 16 should recognise that where financial reporting frameworks have minimal or no related party requirements it is unlikely that entities will have any controls to manage them. The reference to the applicable financial reporting framework in (a) should be removed as the paragraph applies to situations in which there is no such framework. Consideration should be given to the need for a reference to ISA 315 in this paragraph.

5. Paragraphs 22 to 28

The application material supporting the section of responses to assessed risk of material misstatements (paragraph A23-26) should recognise that the nature and extent of substantive procedures will depend on the results of tests of controls, i.e. the reference to tests of controls in A 26 should be brought forward.

6. Special considerations in the audit of smaller entities

Whilst the audit of related parties is often easier in the audit of smaller entities than it is with larger entities, because the auditor is more acquainted with the business dealings of owner managers and those related to them, more guidance on the particular issues involved in auditing related party transactions in smaller entities would be helpful. We agree with the IAASB's conclusion that there should be no blanket exemption from the requirements for smaller entities regarding dominant parties but we would like to see more explicit recognition of the problems faced by auditors of smaller entities in which there are dominant individuals or small groups of individuals. We await the publication of the IFAC ISA guide for smaller entity audits and hope that smaller entity issues such as dominant parties are addressed there if they cannot be addressed in this ISA. We also draw to IAASB's attention to work being performed by the ICAEW's Audit and Assurance Faculty on the audit of related party transactions. We will keep IAASB informed as this project progresses. IAASB should consider the possibility of referring to the related party requirements of the Draft IFRS for SMEs in this ISA.

Paragraph A32, which recognises that in smaller entities the auditor may rely less on evidence of formal authorisation and approval, is welcome, as is paragraph A16 which recognises that in an owner-managed business the only way for the auditor to obtain an understanding of related party relationships and transactions may be through inquiry of management. In practice, as recent history has shown, this will also apply to many larger businesses, even those with formal governance procedures in place.

7. Special considerations in the audit of public sector entities.

No special considerations in the audit of public sector entities have been drawn to our attention.

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