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Accountability * Integrity * Reliability

United States Government Accountability Office
Washington, DC 20548

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Subject: Proposed Statement on Auditing Standards (SAS) - *Related Parties*
(Redrafted)

This letter provides the U.S. Government Accountability Office's (GAO) comments on the Auditing Standards Board's (ASB) September 11, 2009 exposure draft of a proposed Statement on Auditing Standards (SAS) entitled *Related Parties*.

We support the proposed SAS and believe that it will help improve the quality of audits by clarifying an auditor's responsibilities relating to related party relationships and transactions in a financial statement audit. Our responses to the questions on the changes resulting from applying the clarity drafting conventions and converging with International Standard on Auditing (ISA) 550 are provided in this letter. Editorial changes and other comments are included in the attachment to this letter.

Responses to Specific Questions

The Board is also seeking comments on the effect of applying the clarity drafting conventions to the proposed standard and converging it with the International Standards on Auditing. We provide the requested comments below

(1) Are the objectives of the auditor appropriate?

Overall the objectives of the auditor are appropriate. However, the objective related to obtaining an understanding of related party relationships and transactions sufficient for the auditor to recognize risks of material misstatement should not be limited to fraud risk factors but should also include the risk of material misstatement due to errors. This change would align the objective with paragraph 12 of this proposed SAS, which discusses the susceptibility of the financial statements to material misstatement due to fraud or error resulting from related party relationships and transactions. In the attachment to this letter we propose changes to the objective in paragraph 9.a.i.

(2) Are the revisions made to converge the existing standard with ISA 550 appropriate?

We agree with the revisions made to the existing standard to converge with the ISA.

(3) Are the differences between the proposed SAS and ISA 550 identified in the exhibit, and other language changes, appropriate?

The differences between the proposed SAS and ISA 550 identified in the exhibit, and other language changes, are appropriate. We believe, however, that the definition of *related party* in the proposed SAS should be expanded to describe related party, more closely align with the ISA 550 definition, and be framework neutral. Proposed changes to this definition are noted on the attachment.

(4) Have considerations for audits of smaller, less complex entities and governmental entities been dealt with appropriately?

Issues related to audits of governmental entities have not been discussed in this SAS, and we recommend including additional special considerations for audits of governmental entities to provide further guidance. In government entities, related party relationships and transactions may be different from those described in the proposed SAS. For example, ISA 550, paragraph A8, notes the auditor's responsibilities may not be limited to addressing the risks of material misstatement associated with related party relationships and transactions but may also include a broader responsibility to address the risks of non-compliance with law or regulation that have specific requirements for the conduct of business with related parties.

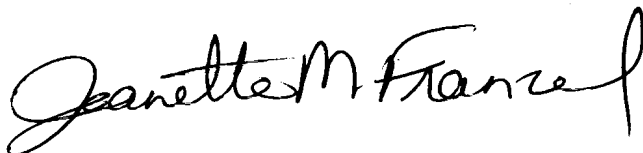
We suggest inserting a paragraph referenced to paragraph 11 that discusses these special government considerations, as follows:

Considerations Specific to Governmental Entities

The auditor's responsibilities in audits of governmental entities may not be limited to addressing the risks of material misstatement associated with related party relationships and transactions but may also include a broader responsibility to assess the risks of non-compliance with laws, regulations, or guidelines that set forth specific requirements in the conduct of business with related parties. Further, government auditors may need to consider financial reporting requirements for related party relationships and transactions that may differ from those in the private sector.

We thank you for considering our comments on these important issues.

Sincerely yours,



Jeanette Franzel
Managing Director
Financial Management and Assurance

GAO Suggested Editorial and Other Changes to Proposed SAS
 “*Related Parties (Redrafted)*”

Suggested Editorial and Other Changes	Reasoning for Suggested Changes
<p>Objectives</p> <p>9. The objectives of the auditor are</p> <p style="padding-left: 20px;"><i>a.</i> to obtain an understanding of related party relationships and transactions sufficient to be able to</p> <p style="padding-left: 40px;"><i>i.</i> recognize fraud risk factors determine the risk of material misstatement due to error or fraud, if any, arising from related party relationships and transactions that are relevant to the identification and assessment of the risks of material misstatement due to fraud.</p> <p style="padding-left: 40px;"><i>ii.</i> conclude, based on the audit evidence obtained, whether the financial statements, insofar as they are affected by those relationships and transactions, achieve fair presentation</p> <p style="padding-left: 20px;"><i>b.</i> to obtain sufficient appropriate audit evidence about whether related party relationships and transactions have been appropriately identified, accounted for, and disclosed in the financial statements <u>and achieve fair presentation.</u></p>	<p>The objective should not be limited to fraud risk factors, but should include the risk of material misstatement due to errors or fraud to better align with the requirement in paragraph 12.</p> <p>Adding “achieve fair presentation” to paragraph 9b will emphasize to auditors that fair presentation is also an important consideration to properly reporting and disclosing related party relationships and transactions.</p>
<p>Definitions</p> <p>10. For purposes of generally accepted auditing standards, the following terms have the meanings attributed as follows:</p> <p style="padding-left: 20px;">related party. A party defined as a related party in GAAP. <u>that is either</u> (Ref: par. A1–A2)</p> <p style="padding-left: 20px;"><u>(i) A related party as defined in the</u></p>	<p>The proposed change adopts the ISA 550 wording to make the proposed SAS framework neutral. However, the last sentence of ISA 550, paragraph 10 is not included in the proposed change since it is not relevant in the U.S.</p>

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<p><u>applicable financial reporting framework;</u> <u>or</u> (ii) <u>Where the applicable financial reporting framework establishes minimal or no related party requirements:</u></p> <p style="padding-left: 20px;"><u>a. A person or other entity that has control or significant influence, directly or indirectly through one or more intermediaries, over the reporting entity;</u></p> <p style="padding-left: 20px;"><u>b. Another entity over which the reporting entity has control or significant influence, directly or indirectly through one or more intermediaries; or</u></p> <p style="padding-left: 20px;"><u>c. Another entity that is under common control with the reporting entity through having:</u></p> <p style="padding-left: 40px;"><u>i. Common controlling ownership;</u></p> <p style="padding-left: 40px;"><u>ii. Owners who are close family members; or</u></p> <p style="padding-left: 40px;"><u>iii. Common key management.</u></p>	
<p>Documentation</p> <p>27. The auditor should include in the audit documentation the names of the identified related parties and the nature of the related party relationships, <u>in addition to the procedures performed and conclusions reached in accordance with the requirements of SAS 103.</u></p>	<p>The proposed change references the requirements of SAS 103 and further develops the documentation requirement.</p>
<p>Responsibilities of the Auditor (Ref: par. 4)</p> <p>A5. Related party relationships and</p>	<p>The proposed change provides a clearer example of the interrelationship between fair</p>

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<p>transactions may cause the financial statements to fail to achieve fair presentation if, for example, the economic reality of such relationships and transactions is not appropriately reflected in the financial statements. For instance, fair presentation may not be achieved if the sale of a property by the entity to a controlling shareholder at a price above or below fair market value has been was properly accounted for as a transaction involving a profit or loss for the entity when it may constitute a contribution or return of capital or the payment of a dividend, <u>but the nature of the relationship was not disclosed. In this case, the transaction would be properly recorded but not fully disclosed, and the failure to disclose the related party relationship precludes fair presentation of the transaction.</u></p>	<p>presentation and disclosure.</p>
<p>A14. <u>Management, with oversight from those charged with governance, is responsible for designing, implementing, and maintaining adequate controls over related party relationships and transactions so that these are identified and appropriately accounted for and disclosed in accordance with the framework. In their oversight role, those charged with governance monitor how management is discharging its responsibility for such controls. Regardless of any related party requirements the framework may establish, those charged with governance may, in their oversight role, obtain information from management to enable them to understand the nature and business rationale of the entity’s related party relationships and transactions.</u></p> <p>The audit is conducted on the premise that management and, when appropriate, those charged with governance have acknowledged</p>	<p>The wording in paragraph A14 of this proposed SAS, although consistent with ISA 550, corresponds with a superseded draft of the Proposed SAS, <i>Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with GAAS</i>. It is not consistent with the final SAS that was approved in 2009. The proposed changes to paragraph A14, based on ISA 550 (paragraph A16) more succinctly convey the important message that management is responsible for the fair presentation of related party transactions, including related internal controls.</p>

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<p>and understand that they have responsibility for the preparation of the financial statements in accordance with the applicable financial reporting framework, including their fair presentation, and for such internal control as management and, when appropriate, those charged with governance determine is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error. Accordingly, the preparation of the financial statements requires management, with oversight from those charged with governance, to design, implement, and maintain adequate controls over related party relationships and transactions so that these are identified and appropriately accounted for and disclosed. In their oversight role, those charged with governance monitor how management is discharging its responsibility for such controls. Those charged with governance may, in their oversight role, obtain information from management to enable them to understand the nature and business rationale of the entity’s related party relationships and transactions.</p>	
<p>A24. Examples of transactions outside the entity’s normal course of business may include the following:</p> <ul style="list-style-type: none"> • Complex equity transactions, such as corporate restructurings or acquisitions • Transactions with offshore entities in jurisdictions with weak corporate laws <u>less rigorous corporate governance structures, laws, or regulations</u> • The leasing of premises or the rendering of management services by the entity to another party if no consideration is exchanged • Sales transactions with unusually large 	<p>The proposed change replaces the terms “offshore” and “weak corporate laws” with more broad reaching terminology.</p>

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<p>discounts or returns</p> <ul style="list-style-type: none"> • Transactions with circular arrangements (for example, sales with a commitment to repurchase) • Transactions under contracts whose terms are changed before expiration 	
<p>Identification and Assessment of the Risks of Material Misstatement Associated With Related Party Relationships and Transactions <i>Fraud Risk Factors Associated With a Related Party With Dominant Influence</i> (Ref: par. 19)</p> <p>A29. Related parties, by virtue of their ability to exert control or significant influence, may be in a position to exert dominant influence over the entity or its management, <u>or alternatively, the entity or its management may exert dominant influence over a related party. For example, the dominant entity might pressure the related party to sell merchandise to the entity at less than cost.</u> Consideration of such behavior is relevant when identifying and assessing the risks of material misstatement due to fraud, as further explained in paragraphs A30–A31.</p>	<p>The proposed change adds balance to the guidance by noting that the audited entity could exert dominant influence over another entity; this is important for auditors to understand when identifying and assessing the risks of material misstatement associated with related party transactions.</p>
<p><i>Assertions That Related Party Transactions Were Conducted on Terms Equivalent to Those Prevailing in an Arm’s Length Transaction</i> (Ref: par. 24)</p> <p>A43. <u>Except for routine transactions, Unless related party transactions are conducted on terms similar to transactions that the entity would conduct with an unrelated party,</u> 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</p>	<p>The proposed change revises text to delete term “routine transactions;” as the proposed SAS does not include a definition of the nature of a “routine transaction.”</p>

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<p>manner of settlement would have been. Accordingly, it is difficult to substantiate representations that a transaction was consummated on terms equivalent to those that prevail in arm’s length transactions.</p>	
<p>Evaluation of the Accounting for, and Disclosure of, Identified Related Party Relationships and Transactions <i>Materiality Considerations in Evaluating Misstatements</i> (Ref: par. 26)</p> <p>A47. The proposed SAS <i>Evaluation of Misstatements Identified During the Audit</i> requires the auditor to consider both the size and nature of a misstatement and the particular circumstances of its occurrence when evaluating whether the misstatement is material. The significance of the transaction to the financial statement users may not depend solely on the recorded amount of the transaction but also on other specific relevant factors, such as the nature of the related party relationship <u>and the adequacy of disclosures.</u></p>	<p>The proposed change emphasizes the importance of considering the adequacy of disclosures when evaluating misstatements.</p>