



BASEL COMMITTEE ON BANKING SUPERVISION

BANK FOR INTERNATIONAL SETTLEMENTS

Chairman

VIA e-mail: EDComments@ifac.org

Mr Jim Sylph
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Exposure draft on 'Related Parties'

Dear Mr Sylph

The Basel Committee on Banking Supervision welcomes the opportunity to comment on your recent exposure draft on 'Related Parties'.

The Committee has a strong interest in international standards for auditing that address the risks of material misstatements arising from either inappropriate accounting for, or nondisclosure of, an entity's related party transactions and believes that this exposure draft includes many useful proposals.

Please find our detailed comments in the attached appendix. These comments have been prepared by the Committee's Accounting Task Force, chaired by Prof Arnold Schilder, Executive Director of the Netherlands Bank, and approved by the Basel Committee. The Committee trusts that you will find its comments useful and constructive.

If you have any questions regarding our comments, please feel free to contact Prof Schilder (+31 20 524 3360), Mr. Marc Pickeur, who chairs the Audit Subgroup of the Accounting Task Force (+32 2 220 5253), or Mr Steven Friedman at the Basel Committee Secretariat (+41 61 280 8096).

Yours sincerely,

Jaime Caruana



Appendix

Basel Committee comments on IAASB exposure draft ISA 550 (revised), Related Parties

1. Introduction

The Basel Committee on Banking Supervision¹ has a strong interest in high quality and independent audits of banks and has carefully analysed the revised proposal pertaining to related parties. The Committee is pleased to note that the Board intends to expand guidance on the audit of related party relationships and transactions by revising the existing ISA 550. The Committee recognises that auditors are faced with many difficult challenges in the audit of related party relationships and transactions and therefore welcomes the Board's initiative to provide updated and expanded guidance on this important subject.

2. Specific observations

Objective to be achieved

The Committee supports the new approach of including an objective to the Standard. As explained in our comment letter on the exposure draft 'Improving the Clarity of IAASB Standards', we are in favour of objectives that represent overall principles that identify what the auditor is trying to achieve and apply to the various situations that the auditor might encounter. We recommend rewording the objective in paragraph 6 accordingly.

Definitions

Paragraph 7 requires the auditor to apply the definitions set out in the Appendix for the purpose of the ISA where the applicable financial reporting framework does not establish related party requirements. These definitions are based on those set out in IAS 24, "Related Party Disclosures". Where the applicable financial reporting framework establishes related party requirements, the related party definitions set out in the framework apply for the purpose of the audit. The Committee is concerned about a situation where the robustness of the applicable financial reporting framework may be questioned and the implications this may

¹ The Basel Committee on Banking Supervision is a committee of banking supervisory authorities, which was established by the central bank Governors of the Group of Ten countries in 1975. It consists of senior representatives of bank supervisory authorities and central banks from Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Spain, Sweden, Switzerland, the United Kingdom and the United States. It usually meets at the Bank for International Settlements in Basel, where its permanent Secretariat is located.

have for the quality of the audit. We understand that the ISA is not intended to impose accounting and disclosure requirements where none are included in the financial reporting framework.

We believe that it would be appropriate to include in paragraph 7 a reference to legal and/or regulatory requirements, other than the applicable financial reporting framework, that could affect the accounting for and disclosure of related party relationships and transactions of entities in some industries. An example is large exposures to related parties in the context of the Basel Committee's Revised Framework: 'International Convergence of Capital Measurement and Capital Standards'. Such an approach would also clarify paragraph A29 where it refers to legal or regulatory requirements that may have a significant effect on the audit.

Requirements - Risk Assessment Procedures

Paragraphs 9 and A1 require the auditor to inquire of management at the beginning of the audit regarding the identity of the entity's related parties and the nature of its related party relationships and transactions. In our view, identifying related parties is a continuous process that extends well beyond the beginning of the audit. Therefore we recommend replacing the word 'at' in 'at the beginning of the audit' with 'from'. The new sentence then becomes: 'The auditor shall inquire of management from the beginning of the audit regarding the identity of the entity's related parties and the nature of its related party relationships and transactions'. Paragraph A1 should be amended accordingly.

Paragraphs 10 and 11 contain key requirements for the auditor. We welcome the introduction of the proposed requirement regarding circumstances where a party appears to actively exert dominant influence over the entity. This requirement recognises that in such circumstances, there is a higher risk of that party overriding management to cause the entity to enter into transactions in which that party is interested. However, the Committee recommends including in the Application Material further explanation about the exact meaning of the new expression 'a party that actively exerts dominant influence over the entity'.

The Committee believes that in addition to this new requirement, it is appropriate that the auditor is required to obtain an understanding of the group structure and to assess the risks of unidentified related parties in (complex) group structures, such as fellow subsidiaries and other related parties. Therefore, we recommend complementing paragraph 11 with an additional point (d), explaining in more detail the requirement to obtain an understanding of and to assess the group structure. In addition, the Application Material should include references to or elaborate on clarified ISA 315.A21-22 (in particular the language about financing and financing activities) and ED ISA 600.11.

We believe that the ISA should highlight the importance of special-purpose entities (SPE) as related parties because such entities may present exposures for which the maximum possible liability is not appropriately reflected in the financial statements of the audited entity. We recommend that the auditor be required to obtain an understanding of the ownership structure of any SPE with which the audited entity is involved and of all significant terms of transactions with it.

We note that the language used in the first line of paragraph 16 is not the same as the wording used in paragraph 10 of the existing ISA. We prefer the existing wording and therefore we recommend adding to the first sentence of paragraph 16, 'and consider the adequacy of'. The sentence then becomes: 'The auditor shall obtain an understanding and consider the adequacy of: ...'

Requirements - Substantive Procedures Responsive to the Risks of Material Misstatements Resulting from Related Parties

Paragraph 18 in effect introduces the section on requirements for responding to a significant risk of material misstatement regarding an arm's length assertion, but does not contain a 'shall'. In line with our comment on the exposure draft 'Improving the Clarity of IAASB Standards', we suggest moving the paragraph to the Application Material. Furthermore, we suggest modifying the last sentence of paragraph 18 by replacing 'may be' by 'is'. The sentence then becomes 'Where this is the case, a significant risk exists that the assertion is misstated'.

Paragraph 20 requires the auditor to request management to withdraw the arm's length assertion when the auditor is unable to obtain sufficient appropriate audit evidence about the assertion. If management disagrees, the auditor shall consider the implications for the auditor's report. We recommend that the auditor also be required to consider the impact on the financial statements.

Requirements - Consequences of Identifying Previously Unidentified or Undisclosed Related Party Relationships or Transactions

Paragraph 21 contains requirements for the auditor when the auditor identifies related party relationships or transactions not previously identified or disclosed by management. We believe that the paragraph's final requirement would be more robust by dropping the opening clause, up to and including the word 'intentional', from (d) and modifying the phrasing as follows: '(d) communicate the non-identification or non-disclosure to those charged with governance, and evaluate the implications for other aspects of the audit...'

Application Material - Risk Assessment Procedures

Paragraph A7 states that in reviewing records or documents, the auditor may identify information that may indicate the existence of previously unidentified or undisclosed related party transactions. The paragraph contains two examples. We recommend adding the following examples:

- Transactions that have unusual terms of trade such as unusual prices, interest rates, guarantees or repayment terms.
- Transactions that seem to lack a logical or business purpose for occurring.

Paragraph A8 gives examples of other types of records or documents the auditor may consider it appropriate to review. We recommend also including the following types of records or documents:

- Previous year's audit working papers.
- Information from other work performed by the auditor or the auditor's firm or by other auditors in the group to which the entity belongs.

In the same paragraph the second bullet point mentions the income tax returns and other information supplied to regulatory authorities as documents the auditor may consider reviewing. We suggest separating the income tax returns from the information supplied to the regulatory authorities as not all entities are regulated.

Paragraph A13 lists examples of relevant features of the control environment. We recommend adding one example:

- Corporate governance ratings attributed by some credit rating agencies.

Appendix

We recommend including in the appendix a reference to paragraph 7 of the ISA.