


International Federation of Accountants

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Agenda Item
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Committee: IAASB
Meeting Location: Lima
Meeting Date: March 7-11, 2005

Related Parties
Objectives of Agenda Item

To review and discuss a first read of the proposed revised ISA 550, “Related Parties.”

Background

The IAASB initiated this project for a number of reasons, including the following:

- The need to reconsider the robustness and appropriateness of ISA 550 given the prominent role played by related parties in a number of recent major corporate scandals.
- Public demands for stronger financial reporting standards addressing the understandability and adequacy of related party disclosures and the auditing thereof.
- The need to revise ISA 550 to be consistent with the Audit Risk Model.

The task force presented an issues paper at the September 2004 IAASB meeting and obtained feedback and guidance from the IAASB for the development of a first draft of the exposure draft.

Activities Since Last IAASB Discussions

The task force met twice in November and December 2004 and held three subsequent conference calls in January and February 2005. The Chair of the task force, Gérard Trémolière, provided an update on the IAASB discussions held in September 2004 to the IAASB CAG at the November 2004 CAG meeting. In addition, the task force considered editorial suggestions on the draft from the Plain English editor, Bob Waller.

Comments on the First Read have been requested from IFAC’s SMP Permanent Task Force. Due to time constraints, the task force did not have an opportunity to meet to discuss them but will do so at its next meeting in April.

The Minimum Disclosure Requirements of International Accounting Standard 24

IAASB Chairman John Kellas wrote to the International Accounting Standards Board (IASB) in June 2004 on behalf of the task force to request that the IASB (a) review International Accounting Standard (IAS) 24, “Related Party Disclosures,” with a view to strengthening IAS 24’s minimum disclosure requirements as a matter of priority, and (b) appoint an appropriate representative to work closely with the task force to address common or overlapping issues. One of the key issues that the task force has identified relates to the understandability of related party disclosures to users of financial statements. The task force noted that IAS 24 has a general requirement for disclosure of “*information* about the [related party] transactions and outstanding balances necessary for an understanding of the potential effect of the [related party] relationship on the

financial statements.” IAS 24, however, does not provide guidance on how preparers and auditors should interpret the term *information*. The task force believes that this lack of guidance makes IAS 24 inadequate and unclear, and would continue to result in inconsistent application of IAS 24.

The International Financial Reporting Interpretations Committee (IFRIC) of the IASB met in September 2004 and discussed the issue. IFRIC, however, resolved not to add the issue to its agenda. IFRIC noted that the IASB, in its revision to IAS 24 in December 2003, had debated the extent of specific minimum related party disclosure requirements and had concluded that no additional requirements were necessary. IFRIC also noted that, because of wider policy considerations, the issue might be appropriate for further discussion at the IASB level and, perhaps, with the IASB’s Standards Advisory Council.

After the meeting between the Chairmen of the IAASB and the IASB in December 2004, it was reported that there had been no further developments on the matter from the IASB. Accordingly, the task force is unable to further address the issue, other than proposing that the auditor should be satisfied that the financial statements comply with the applicable financial reporting framework.

Main Issues

1. ADDRESSING PERCEIVED SHORTCOMINGS IN THE FINANCIAL REPORTING FRAMEWORK

At the September 2004 meeting, the IAASB debated whether the auditor should address perceived shortcomings in the disclosure requirements of the applicable financial reporting framework (FRF) when compared to the requirements of IAS 24. For example, in France, the FRF does not address all the related party disclosures for non-consolidated financial statements that would be required under IAS 24. Specifically, it was questioned whether guidance should be provided for the auditor to follow the requirements and guidance in IAS 24 if the applicable FRF does not address all the disclosures required by IAS 24 – in effect, an accounting override.

It was noted that the application of an accounting override would be illegal in a number of jurisdictions. For this reason, the IAASB agreed that the ISA should not establish such a requirement. Nevertheless, the IAASB requested the task force to consider:

- (a) Whether further guidance regarding the acceptability of the FRF would be appropriate in ISA 550 to address the issue, expanding on the guidance provided by the revised ISA 210, “Terms of Audit Engagements;” and
- (b) Whether it would be appropriate to provide guidance on applying the “stand-back” procedure set out in the revised ISA 700, “The Independent Auditor’s Report on a Complete Set of Financial Statements.”

Acceptability of the FRF

As a result of the recently completed ISA 700 project, guidance in ISA 210 has been reinforced. ISA 210 now states that when law or regulation requires the use of a FRF that the auditor considers unacceptable, the auditor should accept the engagement only if the deficiencies in the FRF can be adequately explained to avoid misleading users of the financial statements. The task force considers related party disclosures to be only one of potentially many areas of financial reporting where the auditor might feel the FRF falls short of acceptable standards. Providing more detailed guidance in ISA 550 to address the auditor’s responsibilities when the FRF is considered not acceptable with regard to related party disclosures would establish a precedent for

other subject-matter ISAs. In addition, the task force noted the IAASB's agreement at the December 2004 meeting that there is currently no objective and authoritative basis that has been generally recognized globally for judging the acceptability of financial reporting frameworks for general purpose financial statements. The IAASB had also noted that objective criteria might be established in the future to evaluate the acceptability of the FRF. Consequently, the task force agreed not to provide further guidance regarding acceptability of the FRF in ISA 550.

Application of the Stand-Back Procedure to Address the Completeness Issue

The task force noted that the auditor may be required to address related party disclosures in both "true and fair/present fairly" and "compliance" reporting situations. Because of the different engagement objectives, the auditor's responsibilities in addressing perceived disclosure shortcomings in the applicable financial reporting framework (an issue of completeness) should not be the same under both sets of circumstances.

In engagements to report a "true and fair/present fairly" opinion, the auditor is required to apply the stand-back procedure in accordance with ISA 700 to evaluate whether the related party disclosures necessary to achieve fair presentation of the financial statements are complete, i.e. they do not cause the financial statements to be misleading. In compliance reporting engagements, the auditor's responsibility is to report only whether the financial statements have been prepared in all material respects in accordance with the requirements of the FRF, without having to determine whether they are fairly presented. Consequently, the auditor's responsibility in the latter case is limited to evaluating whether the related party disclosures comply with the specific requirements of the FRF.

The task force felt that related party disclosures represent such a sensitive area of financial reporting that the ISA should address the issue of shortcomings in the applicable financial reporting framework, distinguishing between these two reporting situations. Accordingly, the task force proposes guidance at paragraphs 68-76.

Applicability of the ISA when the FRF does not Establish Related Party Disclosure Requirements

The task force also considered the applicability of the ISA when (a) the applicable FRF does not establish related party disclosure requirements, and (b) the auditor is only required to report on compliance with the FRF. In particular, the task force debated whether the requirements and guidance in ISA 550 should be relevant even under this circumstance, as related party relationships and transactions may have effects on the financial statements other than as reflected through disclosure, for example, the effects of fraud. The task force noted that other ISAs address the considerations that would be relevant for the auditor in addressing such effects, for example, ISA 240 in dealing with fraud; the audit risk ISAs in dealing with risk assessment and responses; and ISA 200 in dealing with the need for professional skepticism. Consequently, the task force concluded that no further guidance was necessary and, therefore, the ISA should not be applicable in this case.

The decision tree in Appendix A illustrates the guidance proposed by the task force based on the above discussion.

2. UNDERSTANDABILITY OF RELATED PARTY DISCLOSURES

At the September 2004 meeting, the IAASB agreed that the ISA should not establish minimum disclosures necessary for related party transactions to be understandable, since this was an

accounting issue. Nevertheless, the issue of understandability is related to the issue of completeness discussed in Section 2 above, since related party disclosures would not be understandable if necessary parts or elements are omitted from disclosure. Accordingly, the task force believes that the auditor should also apply the stand-back procedure to address the understandability issue prior to finalizing the audit. Guidance relating to this is set out in paragraphs 69-70 of the First Read.

3. EXTENT OF A MINIMUM SET OF AUDIT PROCEDURES

At the June 2004 CAG meeting, CAG members agreed that it would be appropriate to align ISA 550 with the recently issued audit risk standards. They noted, however, that changing to a risk-based approach should not result in abandoning the specific audit procedures set out in the extant ISA. The task force agreed but noted that an approach focused on developing the key principles from an audit risk perspective should result in identifying the minimum audit procedures considered necessary. Accordingly, in addition to proposing a risk-based approach, the task force proposes a number of specific mandatory audit procedures that it considers appropriate in the audit of related party disclosures.

4. EXTENT TO WHICH THE AUDITOR SHOULD BE PROACTIVE

In discussing the possible substantive procedures that would be responsive to assessed risks, the task force debated the extent to which the auditor should be proactive in searching for undisclosed related party transactions. Specifically, the task force discussed the circumstances in which the auditor should be required to proactively review accounting records to identify these transactions. The task force noted the practical limitations to performing detailed reviews of accounting records, especially when these are voluminous. Nevertheless, the task force felt that when the auditor comes across information from the performance of other audit procedures that indicates significant risks of material misstatement due to related parties, the auditor should take proactive steps to address the risks. Accordingly, the task force proposes that when the auditor obtains information from performing other audit procedures indicating significant risks, the auditor should perform additional procedures to respond to the risks. For example, the performance of additional procedures may entail requesting management to perform further work to provide specific additional information from the accounting records, and testing such data. Paragraph 53 of the First Read provides additional examples of the audit procedures the auditor may consider.

5. MEASUREMENT CONSIDERATIONS

The task force debated whether the revised ISA should address measurement considerations, i.e. considerations relating to the measurement of the value of the consideration exchanged in a related party transaction. Measurement issues for related party transactions could arise for various reasons, including the following:

- There is no exchange of consideration;
- Consideration exchanged is non-monetary in nature;
- There is no objective basis of measurement of the consideration exchanged;
- The terms of the transactions are not at arm's length; and
- The transactions are complex.

The task force noted that such issues should effectively be addressed by the national auditing standard setter when the applicable financial reporting framework provides measurement requirements. Accordingly, the task force agreed that the ISA should not address measurement issues.

Material Presented

Agenda Paper 10-A Proposed revised ISA 550, “Related Parties”
(Pages 277-298)

Action Requested

IAASB is asked to review the proposed revised ISA 550 and to provide feedback to the task force in finalizing an exposure draft.

APPENDIX A

