



International Federation of Accountants

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Agenda Item

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Committee: IAASB
Meeting Location: Rome
Meeting Date: June 13–17, 2005

Related Parties

Objectives of Agenda Item

To review and approve for exposure the proposed revised ISA 550, *Related Parties*.

Background

The task force is chaired by IAASB Member Gérard Trémolière, assisted by his technical advisor Cédric Gélard. The other members of the task force are:

- Gen Ikegami – IAASB Member (assisted by his technical advisors Makoto Shinohara and Yuichi Yamamoto)
- Ian Plaistowe – former IAASB Member
- Greg Shields – former IAASB Technical Advisor
- John Thorpe – INTOSAI Representative

The IAASB discussed a First Read draft of the proposed revised ISA at the March 2005 meeting and provided feedback to the task force in preparing a draft exposure draft.

Activities since Last IAASB discussions

Subsequent to the March 2005 IAASB meeting, the task force received comments on the First Read from two members of the IAASB CAG working group on Related Parties, and from another member of the IAASB CAG. The task force met in April 2005 and held a subsequent conference call to discuss the input received and to finalize the exposure draft wording.

Issue of Interpretive Guidance for International Accounting Standard 24

As reported by the task force Chair in March, there were no further developments from the International Accounting Standards Board (IASB) after the IAASB Chairman, John Kellas, wrote to the IASB in June 2004, on behalf of the task force, to request that the IASB consider providing interpretive guidance on the minimum disclosure requirements of IAS 24 as a matter of priority. At a subsequent meeting between the Chairman of the IAASB CAG and the IASB Chairman, the CAG Chairman raised the issue again. As a result, it was agreed that the IAASB Chairman should send a second letter to the IASB, again on behalf of the task force, referring to the same issue under US GAAP so that the IASB Chairman could raise it with the IASB in the context of convergence. This second letter was sent to the IASB on April 28, 2005. The IASB has not yet responded formally.

Main Issues**1. SCOPE OF THE ISA**

In the First Read, the task force had proposed that the ISA would not be applicable for audits where:

- a) The applicable financial reporting framework does not establish related party disclosure requirements; and
- b) The auditor is only required to report whether the financial statements have been prepared, in all material respects, in accordance with the applicable financial reporting framework.

At the March meeting, the IAASB noted that it was unclear whether the standards and guidance in all other ISAs would be sufficiently rigorous to address related party matters if the above scope exclusion applied. Further, the IAASB noted that this explicit scope exclusion raised the broader issue of whether the auditor should consider the acceptability of the applicable financial reporting framework.

It was proposed that a way to resolve the ambiguity caused by the scope exclusion would be to restructure the overarching bold letter principle in the introduction to require the auditor to focus on the risks of material misstatements as a result of the non-identification or non-disclosure of related party transactions. This would replace the original proposal to require the auditor to focus on obtaining audit evidence regarding the identification and disclosure of related party relationships and transactions. As this change would call on the auditor to use professional judgment to determine whether the requirements of the ISA are relevant, it was noted that this would help avoid the need to specifically scope out a particular class of audits.

The task force agreed that reframing the overarching principle of the ISA in terms of addressing risks of material misstatement would be an appropriate way to resolve the issue. Accordingly, the task force has removed the scope exclusion paragraph. The revised overarching principle now requires the auditor to assess and respond to the risks of material misstatements due to related parties in the context of the entity's applicable financial reporting framework, to reduce audit risk to an acceptably low level.

2. TIMING OF INQUIRIES OF MANAGEMENT AND OTHERS WITHIN THE ENTITY

The IAASB asked the task force to reconsider the structure and sequence of the various requirements and guidance in the First Read addressing the auditor's inquiries of management regarding (a) related parties and (b) undisclosed related party relationships or transactions, and how these relate to the auditor's initial communication of the names of related parties to the engagement team when planning the audit.

The task force agreed that the standards and guidance on inquiries could be streamlined as part of the risk assessment process. In addition, the task force reconsidered the requirement for the auditor to communicate the names of identified related parties to the rest of the engagement team, and concluded that this should be broadened to also address the outcome of the risk assessment process relating to related parties. The reason was that, in addition to the identification of related parties, the

risk assessment process would lead to the identification of significant risks and provide the auditor with other relevant related party information. Such information would then be communicated to, and used by, the rest of the engagement team in more effectively designing and performing further audit procedures.

3. SIGNIFICANT AND UNUSUAL TRANSACTIONS

The IAASB asked the task force to consider placing a greater emphasis on identifying significant and unusual transactions, as these transactions would likely present the greatest risks of undisclosed related party relationships and transactions. Guidance could then be provided at a more specific level to address those transactions where there is a concern that related parties might be involved. In addition, the IAASB asked the task force to clarify the inter-relationship between significant risks in the context of related parties, and transactions that are significant and unusual.

The task force agreed with this approach and has redrafted the requirements and guidance addressing substantive procedures responsive to assessed risks. There is now more emphasis on the identification of significant and unusual transactions (paragraphs 42-45). The task force has also clarified the inter-relationship between significant and unusual transactions, and significant risks (paragraphs 33-34).

4. LINKAGE WITH THE FRAUD ISA

The IAASB asked the task force to consider whether the proposed revised ISA could be more fully integrated with the Fraud ISA (ISA 240). It was noted, in particular, that ISA 240 already has a requirement for the auditor to understand the business rationale of significant transactions, and this requirement could be linked to the proposal to place a greater emphasis on the identification of significant and unusual transactions.

The task force agreed that it would be appropriate to improve the linkage to ISA 240 in this way. Accordingly, the task force has redrafted the section on substantive procedures responsive to significant risks. There is now a link to the requirement in ISA 240 to understand the business rationale of significant transactions (paragraph 49). At the same time, the task force noted that further linkage to ISA 240 did not appear necessary in view of the guidance that has already been provided (paragraphs 4(e), 7(d), 12, 26, 28 and 77).

5. COMMUNICATION WITH THOSE CHARGED WITH GOVERNANCE

The IAASB asked the task force to consider expanding the requirement and guidance addressing communication with those charged with governance to include, more broadly, discussions of the nature and extent of material related party transactions. The reason was that a broader discussion would better enable the auditor to communicate his or her views regarding how related party transactions have affected the financial statements.

The task force agreed and has amended the section on communication with those charged with governance accordingly. In addition, the task force felt that it was important to retain an emphasis on

a discussion of those transactions that involve actual or perceived conflicts of interest (paragraph 62). In support of this, the task force proposes to add a definition of “conflict of interest” in the Definitions section of the ISA in relation to management and those charged with governance.

6. REPORTING ON A TRUE AND FAIR FINANCIAL REPORTING FRAMEWORK

The IAASB noted that circumstances might exist where law or regulation requires the auditor to report whether the financial information audited complies with the requirements of a financial reporting framework designed for fair presentation, without specifically requiring the auditor to express a “true and fair/present fairly” opinion. It was noted that in such circumstances, the auditor would still need to consider whether the related party disclosures support the objective of fair presentation that the financial reporting framework requires.

The task force agreed and, accordingly, has redrafted the requirement and guidance on evaluation of related party disclosures when the framework is designed for fair presentation. The basic principle now states that when the objective of the engagement is to report on financial statements prepared in accordance with such a framework, the auditor should evaluate whether the related party disclosures are presented in a manner that achieves fair presentation of the financial statements (paragraph 68).

Material Presented

Agenda Item 7-A Proposed revised ISA 550 (Clean)
(Pages 949 - 972)

Agenda Item 7-B Proposed revised ISA 550 (Markup)
(Pages 973 - 1002)

Action Requested

The IAASB is asked to consider the above issues and approve the proposed revised ISA 550 for issue as an exposure draft.