



International Federation of Accountants

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Agenda Item

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Committee: IAASB
Meeting Location: Cape Town
Meeting Date: December 5–9, 2005

Related Parties

Objective of Agenda Item

To review and approve for exposure the proposed revised ISA 550, *Related Parties*, prepared under the proposed Clarity drafting convention.

Background

The members of the task force are:

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

The IAASB discussed a second read of the proposed exposure draft (ED) in the current drafting convention at the September 2005 meeting. The IAASB agreed that the task force should finalize a draft prepared under the proposed Clarity convention for approval as an ED at the December 2005 meeting.

Activities since Last IAASB discussions

The task force met in October 2005 and held two subsequent conference calls to discuss the input received from the IAASB and to finalize the wording for the proposed ED.

The task force also considered editorial comments from Bob Waller, who reviewed the Clarity draft from a plain English perspective.

Main Issues

1. NATURE AND EXTENT OF MANDATORY IDENTIFICATION PROCEDURES

At the September 2005 meeting, the IAASB broadly agreed that the proposed mandatory procedures to identify related party relationships and transactions not identified or disclosed by management should be considered part of the auditor’s risk assessment procedures. It was questioned whether it

was necessary to require the auditor to review specific types of documents (i.e., minutes of meetings, shareholder records, income tax returns and investment records) as part of these identification procedures. Although this requirement was not new (the extant ISA already requires the auditor to review such specific documents), the IAASB asked the task force to consider whether it would be more appropriate to include these documents within the application material as part of a broader list of *possible* documents that the auditor could review.

The task force reconsidered the rationale for proposing a requirement for the auditor to review specific types of documents and concluded that there is justification (on the grounds of the reliability and relevance of the evidence they may provide, and the practicality of obtaining it) to require the auditor to review the following four types of records or documents in all cases:

- (a) Bank, legal and other third party confirmations;
- (b) Minutes of meetings of shareholders and those charged with governance, and other relevant statutory records;
- (c) Shareholder records, to identify the entity's principal shareholders; and
- (d) Records of the entity's investments.

The task force believes that listing these types of documents as part of application material, as opposed to explicitly requiring the auditor to review them, would not only lead to inconsistent application by practitioners, but also to a weakening of the ISA. The IAASB CAG has also supported this approach of requiring the performance of specific identification procedures. Nevertheless, the task force agreed that it would be appropriate to provide guidance in terms of *other* types of records or documents that the auditor might judge appropriate to also review (see paragraph A17).

At the September 2005 meeting, the IAASB also noted that the proposed requirement to identify (a) significant and unusual transactions, and (b) special-purpose entities, was more in the nature of objectives than specific procedures, and asked the task force to clarify the nature of the procedures that would achieve such objectives. The task force has therefore amended the proposal by requiring the auditor to identify transactions that are both significant and non-routine through inquiries of management and others within the entity, and review of the specific types of records or documents discussed above. In addition, the task force concluded that it was unnecessary to require the auditor to identify special-purpose entities as (a) such entities are not commonplace (and therefore understood) in the majority of industries, and (b) they would likely be identified as part of the auditor's procedures to identify significant and non-routine transactions.

2. REFERENCE TO INTERNATIONAL ACCOUNTING STANDARD (IAS) 24

Paragraph 4 of the extant ISA 550 states that "definitions regarding related parties are given in IAS 24, *Related Party Disclosures*, and are adopted for the purposes of the ISA." Although the proposed

ED retains a similar reference to IAS 24,¹ the task force had varying views of the role that IAS 24 should play in the revised ISA. Specifically, the task force debated whether the proposed ED should:

- (a) Establish the related party definitions in IAS 24 as a minimum, or
- (b) Refer the auditor to the IAS 24 definitions for information purposes only.

The task force noted that option (a) would have the benefit of establishing an international benchmark that would be appropriate to address not only circumstances where the applicable financial reporting framework does not provide related party definitions, but also circumstances where the framework provides definitions that would be considered inadequate (and therefore potentially resulting in misleading financial statements) relative to IAS 24. This option would be consistent with the proposed requirement for the auditor to perform a minimum set of risk assessment procedures when the framework does not establish related party disclosure requirements (paragraph 6 in the proposed ED). The task force recognized, however, that this option would result in the proposed revised ISA 550 not being framework-neutral. It would also set a precedent for other ISAs in terms of mandating the definitions in international financial reporting standards as minimum requirements, and effectively introduce an accounting override in situations where the framework is considered “deficient.”

The task force noted that although option (b) is framework-neutral and would not introduce an accounting override, its meaning would be ambiguous as it would not clearly mandate that the auditor use the IAS 24 definitions when the framework does not provide related party definitions.

The task force did not reach a final consensus on which option should be implemented in the proposed ED (or indeed whether this issue should be addressed in this project and the reference to IAS 24 deleted), pending further discussion with the IAASB.

3. FINANCIAL REPORTING FRAMEWORKS THAT DO NOT REQUIRE RELATED PARTY DISCLOSURES

At the September 2005 meeting, the IAASB asked the task force to further clarify the underlying rationale for the proposed requirement for the auditor to perform risk assessment procedures if there are no related party disclosure requirements in the applicable financial reporting framework. The previous draft explained that the auditor would obtain an understanding, through the performance of these risk assessment procedures, of the nature and extent of the entity’s related party relationships and transactions to evaluate whether the financial statements are likely to be misleading. It was noted that this explanation could be misinterpreted as it gave the impression that there would be a presumption that the financial statements are misleading before the start of the audit. The task force agreed that this was not the intention and concluded that the rationale is really in two parts:

- (a) To enable the auditor to evaluate the significance of related party relationships and transactions *to the entity*; and

¹ Paragraph 4 of the proposed ED (Redrafted) states: “The Appendix sets out the definitions in International Accounting Standard 24 regarding related parties to assist the auditor in understanding the requirements and application material of this ISA.”

- (b) To enable the auditor to evaluate whether their effects could result in the financial statements being misleading in the *circumstances of the engagement*.

This amended rationale is accordingly reflected in the revised draft. In addition, at the IAASB's request, the task force has inserted specific paragraph cross-references to clarify the risk assessment procedures that the auditor would be required to perform in these circumstances.

4. RELATED PARTY RELATIONSHIPS AND TRANSACTIONS INVOLVING A DOMINANT RELATED PARTY

The previous draft proposed that the auditor's understanding of the entity should include obtaining an understanding, *where practicable*, of the nature, extent and business rationale of the relationships that the entity's principal owners have with parties that are related to them, particularly where these principal owners exercise significant or dominant influence over the entity. While the guidance was considered relevant, it was noted that the use of the term "where practicable" would weaken the guidance and would not promote consistent practice. The IAASB therefore asked the task force to consider structuring the guidance in terms of (a) identifying parties related to the principal owners, and (b) identifying transactions between the entity and these parties.

The task force reconsidered the underlying rationale for the guidance in light of the IAASB's comments and concluded that there should be a requirement for the auditor to (a) *seek* to identify the parties related to the dominant party, and (b) for those parties that have been so identified, to understand the nature of the business relationships that they might have established with the entity. In the task force's view, the term "seek to" enables the ISA to achieve an appropriate balance between requiring the auditor to be proactive in such circumstances, and recognizing that there may be practical limitations to the extent of information the auditor might be able to obtain. The task force also decided to clarify the guidance by placing the focus on a controlling party able to exert dominant influence over the entity, rather than on a principal owner able to exercise significant or dominant influence over the entity.

Material Presented

Agenda Item 4-A (Pages 2403 – 2428)	Revised Draft of the Proposed Revised ISA 550 (Markup from September Draft – Current Drafting Convention)
Agenda Item 4-B (Pages 2429 – 2444)	Revised Draft of the Proposed Revised ISA 550 (Clean – Current Drafting Convention)
Agenda Item 4-C (Pages 2445 – 2460)	Proposed ED of the Revised ISA 550 (Redrafted)
Agenda Item 4-D (Pages 2461 – 2478)	Mapping Document

Action Requested

The IAASB is asked to consider the above issues and approve the proposed revised ISA 550 (Redrafted) for exposure.