

IAASB CAG PAPER



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Agenda Item

A.2

Committee: IAASB Consultative Advisory Group

Meeting Location: Paris

Meeting Date: May 11-12, 2006

November 30-December 1, 2005 Report Back—

Proposed ISA 550 (Revised), Related Parties

Objectives of Agenda Item

To provide a brief report-back on the June 2005 proposals of CAG on the proposed revised ISA 550, “Related Parties,” and on significant changes implemented on the revised draft of the proposed revised ISA, which will be discussed at the IAASB’s December 2005 meeting.

The agenda for this meeting provides for a 15-minute discussion of this report.

June 2005 CAG Proposals

Although not a complete extract from the minutes of the June 2005 CAG meeting minutes,¹ the text below contains all the proposals made by CAG members. It also indicates the related response of the IAASB task force or the IAASB.

FINANCIAL REPORTING FRAMEWORKS THAT DO NOT REQUIRE RELATED PARTY DISCLOSURES

Mr Roussey noted that the approach taken by the proposed ISA has been changed by providing standards and guidance that address the auditor’s responsibilities both when the applicable financial reporting framework addresses related party disclosures and when it does not. He was of the view that the proposed ISA should not go beyond the applicable financial reporting framework.

The IAASB believed that, even if the applicable financial reporting framework did not require related party disclosures, it was important for the auditor to obtain an understanding of the nature and extent of the entity’s related party relationships and transactions sufficient to evaluate:

- (a) Their significance to the entity; and*
- (b) Whether their effects could result in the financial statements being misleading in the circumstances of the engagement.*

¹ The minutes will be approved at the November/December 2005 CAG meeting.

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PERCEIVED OVER-EMPHASIS ON HIGH RISK RELATED PARTIES

Mr Popham noted that the proposed ISA was focused on high risk related parties and created many unnecessary “should” requirements for auditors of ordinary entities with ordinary related parties (e.g., sister companies that are part of single supply chain).

The IAASB agreed that in many cases, related party relationships and transactions will be of a straightforward nature and therefore will not present any significant issues. The IAASB noted, however, that circumstances often exist where these relationships and transactions give rise to higher risks of material misstatement, for example, where related party transactions involve family members of management that are not fully documented or formally approved. The proposed revised ISA requires the auditor to perform sufficient work to understand those circumstances, and assess and respond to the identified risks.

Other Significant Changes Made to the Revised Draft of the Proposed Revised ISA

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. 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 in the proposed revised ISA).

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, for the purpose of

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identifying previously unidentified related party relationships and transactions, was more in the nature of objectives than specific procedures. Accordingly, the task force has amended the proposal to require 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.

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, the IAASB noted that the use of the term “where practicable” would weaken the guidance and promote inconsistent practice.

The task force therefore reconsidered the rationale for the guidance and agreed to amend it so as to require the auditor to (a) *seek* to identify the parties related to the dominant party, and (b) for those parties that have been so identified, 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 as 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

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Nov.30-Dec. 1, 2006
Meeting Material

Proposed Revised ISA 550 (Redrafted), “Related Parties” – FOR
REFERENCE PURPOSES ONLY