



International Federation of Accountants

545 Fifth Avenue, 14th Floor, New York, NY 10017 USA

Tel +1 (212) 286-9344 Fax +1 (212) 286-9570 www.ifac.org

Agenda Item

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Committee: IAASB

Meeting Location: New York

Meeting Date: September 12–16, 2005

Related Parties

Objectives of Agenda Item

- 1) To review a second read draft of the proposed revised ISA 550, *Related Parties*.
- 2) To obtain the IAASB's views regarding the meaning of the present tense used in the revised draft, and which of the occurrences of the present tense addressing the auditor's actions should be elevated to requirements.

Background

The IAASB discussed a first read of the proposed exposure draft at the June 2005 meeting. The IAASB Chairman also had an opportunity to brief the IAASB CAG on the more significant issues arising from the project at the CAG meeting held earlier in June, and relayed the CAG's guidance to the IAASB and the task force at the June 2005 IAASB meeting.

Activities since Last IAASB discussions

The task force met in July 2005 and held two subsequent conference calls to discuss the input received and to finalize the wording for the second read.

Main Issues

1. FINANCIAL REPORTING FRAMEWORKS THAT DO NOT DEAL WITH RELATED PARTIES

At the June CAG meeting, the CAG had questioned the nature of the auditor's responsibilities when the applicable financial reporting framework does not deal with related parties, and if the auditor should have responsibilities, whether the ISA should clearly articulate them. The IAASB noted that although the auditor would be unable to require management to account for or disclose related party relationships and transactions when these are not required by the applicable financial reporting framework, there could be a risk that the financial statements might be misleading because of these relationships and transactions, notwithstanding the absence of any disclosure requirements in the framework.

The IAASB concluded that the auditor should have some responsibility in such situations, and that such responsibility should include obtaining an understanding of the entity's related party relationships and transactions, and their financial effects, sufficient to evaluate whether the financial

statements are likely to be misleading. Accordingly, the task force has proposed guidance to that effect in paragraph 3.

The IAASB also questioned whether the ISA should provide specific guidance on the meaning of misleading financial statements in this context. It was noted that guidance on the auditor's considerations regarding misleading financial information was already provided in ISA 700, "The Independent Auditor's Report on a Complete Set of General Purpose Financial Statements," and the proposed revised ISA 701, "The Independent Auditor's Report on Other Historical Financial Information." Accordingly, the task force does not propose further explanatory guidance on misleading financial information in ISA 550. Instead, the task force proposes to footnote an appropriate cross-reference in paragraph 3 to ISA 700 and the proposed ISA 701. The task force agreed it would also be appropriate to footnote a cross-reference to Section 110 of the revised IFAC Code of Ethics issued in June 2005, in relation to the requirement for a professional accountant not to be associated with misleading financial information.

2. NATURE, TIMING AND EXTENT OF WORK EFFORT IN ADDRESSING RISKS

At the June meeting, the IAASB debated the nature, timing and extent of the auditor's work effort in addressing the risks of material misstatement resulting from related parties. It was noted that there was ambiguity regarding whether the proposed procedures to identify related party relationships and transactions were mandatory, or whether they were subject to the auditor's assessment of risks. The proposed inclusion of identification procedures as part of the response to assessed risks also gave the impression that these procedures would be performed later in the audit than would be expected.

The IAASB agreed that the main risk with related party relationships and transactions is the risk of non-identification, but generally did not agree with a proposal to introduce a rebuttable presumption of significant risk of non-identification to drive the performance of mandatory identification procedures. The IAASB recommended that the ISA should indicate that, because of the special nature of related parties, certain identification procedures should always be carried out as part of the auditor's risk assessment procedures. Accordingly, the task force has built a requirement to perform specific identification procedures into the auditor's risk assessment procedures. In addition, to fulfill the requirements of ISAs 315 and 330, the auditor would still have to assess other risks and to design further audit procedures that respond to such risks. On this basis, the risk assessment section of the ISA is now structured as follows:

- (a) A discussion of related party matters among the engagement team during audit planning (paragraphs 9-10);
- (b) Obtaining an understanding of the entity's related party relationships and its related party controls (paragraphs 11-21); and
- (c) Performing specific procedures with the objective of identifying related party relationships and transactions not identified or disclosed by management (paragraphs 22-26).

3. NATURE AND EXTENT OF IDENTIFICATION PROCEDURES

At the June meeting, the IAASB noted the need to clarify the nature and extent of the procedures that the auditor should perform to identify related party relationships and transactions not identified or disclosed by management. After discussion, the task force concluded that there should be 4 types of procedures that the auditor should perform to achieve that objective:

- (a) Inquiries of individuals other than management and those charged with governance;
- (b) Review of relevant documentation;
- (c) Identification of significant and unusual transactions; and
- (d) Identification of special-purpose entities that have some connection with the entity or its principal officers.

The task force believes that the broad scope and targeted nature of these procedures are appropriately balanced to drive the auditor's work in identifying related party relationships and transactions not identified or disclosed by management.

In relation to the review of relevant documentation as one type of identification procedure, the IAASB questioned whether it would be appropriate or practicable for the auditor to review bank and other third party confirmations, given that these would ordinarily be reviewed at a later stage in the audit. The task force agreed and concluded that the most appropriate response from the auditor should be to remain alert for evidence of unidentified or undisclosed related party relationships or transactions when reviewing these confirmations. This guidance has been placed in the risk assessment section dealing with discussions among the engagement team (paragraph 10).

In addition, the task force proposes to limit the types of documents that the auditor should always review for the purpose of identification to the following:

- (a) Minutes of relevant meetings;
- (b) Relevant statutory records;
- (c) Income tax returns and other relevant regulatory information; and
- (d) Records of the entity's investments and, where practicable, those of its pension plans.

The auditor would, of course, be free to review further documentation considered appropriate if a significant risk of non-identification is assessed.

4. EVALUATING THE RELATIONSHIPS BETWEEN THE ENTITY'S PRINCIPAL OWNERS AND PARTIES RELATED TO THEM

The task force had proposed that the auditor's understanding of the entity should include obtaining an understanding 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 task force agreed that such guidance should strengthen auditor performance in addressing situations such as Maxwell in the UK, there was some disagreement among task force members regarding whether the guidance should be softened, as the implied work effort involved to obtain the required understanding did not appear to take into account the potential difficulties that could arise in practice (for example, limitations on access to information). The majority of the task force agreed that it would be appropriate to frame the guidance within the bounds of practicality. Accordingly, the task force proposes that such understanding be obtained *where practicable*.

5. SUBSTANTIVE PROCEDURES TO RESPOND TO ASSESSED RISKS, INCLUDING SIGNIFICANT RISKS

As mentioned in issue 2 above, the IAASB questioned the appropriateness of including identification procedures as part of the auditor's response to assessed risks. After restructuring the document and moving the identification procedures to the risk assessment section, the task force concluded that it

would be sufficient to simply include a cross-reference to ISA 330, as the nature, timing and extent of further audit procedures that the auditor should design to respond to assessed risks would vary with the nature of the risks and the particular circumstances of the entity. As such, it would not be practicable for the ISA to prescribe the nature and extent of audit procedures that would respond to assessed risks (including significant risks) in all circumstances.

Nonetheless, the task force agreed that it would be appropriate to provide some guidance on the types of substantive procedures that would be responsive to significant risks, for example, to address significant risks regarding non-identification, or regarding the accounting or disclosure of specific related party transactions (paragraph 34).

6. MEANING OF PRESENT TENSE

The task force has reviewed the occurrences of the present tense in the draft revised ISA and has agreed, on a preliminary basis, which of these should be elevated to professional requirements (see Agenda Item 3-C). The IAASB is asked for its views on the meaning of the present tense in the explanatory guidance of the ISA as it relates to auditor actions.

Material Presented

Agenda Item 3-A (Pages 1601 - 1618)	Proposed revised ISA 550 (Clean)
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Agenda Item 3-B (Pages 1619 - 1652)	Proposed revised ISA 550 (Markup)
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Agenda Item 3-C (Pages 1653 - 1660)	Proposed Disposition of the Present Tense in the Draft Revised ISA 550
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Action Requested

The IAASB is asked to consider the above issues and provide input to the task force in preparing a revised draft, redrafted in the Clarity format, for approval for issue as an exposure draft at the December 2005 meeting.