



International Federation of Accountants

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Agenda Item

8

Committee: IAASB

Meeting Location: New York

Meeting Date: February 13-16, 2007

Related Parties

Objective of Agenda Item

1. To review and approve for re-exposure a revised draft of the proposed revised ISA 550, *Related Parties*.

Task Force Composition

2. The members of the task force are:
 - Gérard Trémoлиère – Chair, IAASB Member (assisted by his Technical Advisor Cédric Gélard)
 - Jon Grant – IAASB Technical Advisor
 - Diana Hillier – IAASB Member
 - Greg Shields – IAASB Technical Advisor
 - Makoto Shinohara – IAASB Member (assisted by his Technical Advisor Yuichi Yamamoto)
 - John Thorpe – INTOSAI Representative

Activities since Last IAASB discussions

3. The task force met in January to discuss the significant comments received from the IAASB at the December 2006 meeting on a second-read draft of the proposed revised ISA post-exposure. The task force held a subsequent conference call to finalize the wording of the draft now being presented.

Significant Issues

- A. EVALUATION OF WHETHER THE FINANCIAL STATEMENTS ACHIEVE FAIR PRESENTATION OR ARE MISLEADING IN THE CONTEXT OF RELATED PARTIES
4. The second-read draft of the ISA proposed that one of the objectives of the auditor should be to obtain sufficient appropriate audit evidence that the financial statements, as a whole:
 - (a) Achieve fair presentation (if they are prepared and presented in accordance with a fair presentation framework); or

- (b) Are not misleading (if they are prepared and presented in accordance with a compliance framework)
 - on the basis that they appropriately reflect the economic reality of the related party relationships and transactions.
- 5. At the December meeting, it was noted that the proposed wording in the previous draft gave the impression that the ISA placed a new responsibility on the auditor to perform a stand-back test in the context of related parties. The task force agreed that this was not the intention. To clarify that obtaining an understanding of related party relationships and transactions provides support to the stand-back evaluation that is required under ISA 700 (as opposed to leading to a separate stand-back test), the task force has amended the description of the auditor's responsibility to understand related party relationships and transactions to more directly link such responsibility to the stand-back requirement in ISA 700. This amended wording states that even if the applicable financial reporting framework establishes minimal or no related party requirements, the auditor nevertheless needs to obtain an understanding of the related party relationships and transactions sufficient to be able to form the opinion, in accordance with ISA 700, on whether the financial statements:
 - (a) Achieve fair presentation (for fair presentation frameworks); or
 - (b) Are not misleading (for compliance frameworks) (see paragraph 6).
- 6. The task force has also revised the corresponding wording of the objective to be consistent with this amended description of the auditor's responsibility (see paragraph 12).

Matter for IAASB Consideration

- Q1. Does the IAASB agree with the amended description of the auditor's responsibility and the revised objective in relation to the need for the auditor to obtain an understanding of related party relationships and transactions even if the framework establishes no related party requirements?

B. NATURE AND EXTENT OF WORK EFFORT IN INQUIRIES OF MANAGEMENT

- 7. At the December meeting, some members questioned the appropriateness of limiting the requirement for the auditor to make inquiries of management regarding the identity of the entity's related parties (and the associated inquiries regarding the nature of the related party relationships and transactions) to only those circumstances where the applicable financial reporting framework defines related parties. It was noted that it was unclear why, even if the framework has no related party definitions, the auditor would not also ask management about who the main parties are with whom the entity has "related party" relationships and the nature of any business undertakings between them and the entity, simply from the point of view of understanding the business. It was argued that such an inquiry would not be too demanding for management because, even if the framework does not deal with related parties, management should know the identity of the parties that are controlling the entity or have significant influence on it (and vice versa).

8. The task force notes that the main reason for its proposal to limit the inquiries to circumstances where the framework defines related parties was to avoid the practical difficulties that would likely arise from trying to ask management to identify a list of related parties and related party transactions based on definitions and guidance that exist only in an auditing standard. In the absence of specific reporting requirements regarding related parties, management may not have established the systems and controls to capture such information. Furthermore, a primary objective of making the nature and extent of the inquiries as set out in the December draft was to have a starting point from which to assess the risks of material misstatement arising from unidentified related parties and related party transactions – the completeness of which is not an issue in the absence of a requirement for management to disclose all of them in the financial statements.
9. For these reasons, the task force had proposed in December to focus the auditor's work effort, in circumstances when management does not have any reporting obligations under the applicable financial reporting framework, on probing significant unusual transactions identified in the course of the audit and the controls around them. Together with the understanding of the parties who control or significantly influence the entity (and vice versa) obtained as part of the auditor's understanding of the nature of the entity (as required in ISA 315), the auditor would have a sound basis for identifying fraud risk factors and matters that could influence the fair presentation of the entity's financial results (or render them misleading, in the case of a compliance framework)
10. Based on the comments at the December meeting, however, the task force agrees that it would be useful to more explicitly require discussion with management about the parties who control or significantly influence the entity (and vice versa) in this ISA to give greater visibility to the nature of the dialogue with management in this regard, which is relevant in obtaining a robust understanding of the entity. However, the task force believes that such inquiries would only be practicable if they are in the nature of a *general* discussion not intended to lead to a requirement to, or perception that the objective is to, compile complete lists of related parties and related party transactions. Thus, the nature and extent of the work effort expected when there are related party reporting requirements and when there are not, differ.
11. Accordingly, the task force proposes that, as part of obtaining an understanding of the nature of the entity as required by ISA 315, and regardless of whether the framework defines related parties, the auditor shall discuss with management the identity of the parties that control or significantly influence the entity (or vice versa), and the nature of any business undertakings between the entity and these parties. The task force believes that the aim of this discussion should not be to identify *all* parties that might qualify to be related under the broad definition proposed in the ISA. Therefore, the discussion is focused specifically on those parties that *control or significantly influence* the entity, as opposed to all parties that might have the *ability* to control or significantly influence the entity (see paragraph 16).
12. In addition, the task force believes that where the framework has established related party definitions and requirements, the auditor should have a responsibility to obtain from management the names of the related parties that management has identified to meet those

requirements, and make inquiries of management in relation to such a “list” regarding the nature of the related party relationships and transactions (see paragraph 17).

13. The task force acknowledges that separating the two proposed requirements in paragraphs 16 and 17 gives rise to a certain degree of overlap, given that in cases where the framework definitions are adequate for the purposes of the ISA, the auditor should be able to achieve the purpose of paragraph 16 by fulfilling the requirement in paragraph 17. However, in cases where the framework has only weak or no related party definitions and requirements, the discussion proposed under paragraph 16 would enable the auditor to obtain a greater amount of information that would be relevant for risk assessment purposes.

Matter for IAASB Consideration

- Q2. Does the IAASB agree with the proposed revised approach regarding the nature and extent of inquiries of management?

C. IMPLICIT ARM’S LENGTH ASSERTIONS

14. At the December meeting, the IAASB debated the need to develop guidance to address implicit arm’s length assertions that management may make under certain financial reporting frameworks (specifically in Europe).¹ There was some concern that it would be inappropriate to include guidance in the ISA to deal with this issue, which is very specific to a particular jurisdiction, and it was suggested that it might be preferable to let the jurisdiction concerned address the issue at the local level.
15. It was, however, noted that including some guidance in the ISA at this stage would alert auditors to the existence of the issue, and that any consensus solution that relevant national standard setters might identify in due course could be considered for inclusion in the ISA before its finalization. There was overall support from the IAASB for this approach. Accordingly, the task force has proposed some guidance to the effect that if management makes an implicit arm’s length assertion, the auditor would need to consider how to obtain sufficient appropriate audit evidence regarding such an assertion (see paragraph A26).
16. In addition, in view of the significant amount of audit work that becomes mandatory for significant risks, the task force believes that the treatment of arm’s length assertions as significant risks should only be limited to *explicit* assertions at this stage, until an agreement on a solution is reached to deal with implicit assertions (see paragraph 23).

Matters for IAASB Consideration

- Q3. Does the IAASB agree with the task force’s proposed guidance regarding implicit arm’s length assertions?
- Q4. Does the IAASB agree that the treatment of arm’s length assertions as specific risks should be

¹ This issue arises specifically in the context of the European Union’s revised 4th and 7th Directives, which require the disclosure of related party transactions *not* conducted under normal commercial or market terms.

limited to *explicit* assertions only at this stage?

D. CONSIDERATION OF THE NEED FOR RE-EXPOSURE

17. Given the nature and extent of the changes from the exposure draft, the task force believes the revised draft should be re-exposed for comment.

Matter for IAASB Consideration

Q5. Does the IAASB agree that the revised draft of the ISA should be re-exposed?

Material Presented

Agenda Item 8-A Revised Draft of the Proposed Revised ISA 550 (Mark-up from
(Pages 517 – 540) December 2006 meeting)

Agenda Item 8-B Revised Draft of the Proposed Revised ISA 550 (Clean)
(Pages 541 – 560)

Draft of the ISA to be Discussed at the Meeting

The task force proposes that the **mark-up** version of the revised draft (**Agenda Item 8-A**) be discussed at the meeting.

Action Requested

The IAASB is asked to consider the above issues and approve the revised draft of the proposed revised ISA 550 for re-exposure.

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