



**International Federation of Accountants**

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## Agenda Item

# N

**Committee:** IAASB Consultative Advisory Group

**Meeting Location:** Toronto

**Meeting Date:** September 11-12, 2006

### **Related Parties—Significant Comments on the Exposure Draft of Proposed Revised ISA 550**

#### **Objective of Agenda Item**

To receive a report on the significant comments received on the exposure draft of Proposed Revised ISA 550, “Related Parties” (ED 550), and to discuss the task force’s preliminary recommendations.

#### **Background and Overall Comments**

1. The IAASB issued ED 550 at the end of December 2005, with a comment deadline of April 30, 2006. A total of 41 comment letters have been received. The IAASB will discuss the significant comments received at its September 18-22, 2006 meeting.
2. Overall, respondents to the exposure draft supported revising the ISA. Most welcomed the IAASB’s proposal to establish a risk-based approach to the audit of related party relationships and transactions. Respondents, however, raised significant comments regarding the following aspects of the exposure draft:
  - (a) The inter-relationship of the proposed ISA with the audit risk and fraud ISAs, and the differentiation between risk assessment procedures and responses to risks.
  - (b) The emphasis in ED 550 on the inherent limitation in identifying related party relationships and transactions.
  - (c) The use of related party definitions based on those in extant International Accounting Standard (IAS) 24 when the applicable financial reporting framework does not establish related party definitions and requirements;
  - (d) The approach to identifying previously unidentified or undisclosed related party relationships or transactions through the performance of procedures to identify and understand significant non-routine transactions;
  - (e) The performance of procedures intended to identify the parties to which a dominant party is related; and
  - (f) The requirement to review appropriate entity records or documents for significant non-routine transactions.

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**Significant Issues for Consideration by the IAASB CAG**

**A) INTER-RELATIONSHIP WITH THE AUDIT RISK AND FRAUD ISAs, AND RISK ASSESSMENT PROCEDURES VS RESPONSES TO RISKS**

3. In contrast to the procedural nature of the extant ISA, ED 550 adopted a risk-based approach to the audit of related party relationships and transactions. Several respondents noted that the inter-relationship with the audit risk and fraud ISAs was unclear in the document. In particular, a number of them perceived a lack of context for the proposed risk assessment procedures, which they believed led these procedures to appear to be an isolated and complete set of procedures relating exclusively to related parties, although many of these derive from requirements in these other ISAs. Accordingly, they thought that more could have been done to explain this inter-relationship.
4. Some of the respondents also felt that ED 550 gave the impression that *all* related party transactions represent significant risks. They argued that the vast majority of related party transactions are routine transactions occurring mostly within groups of companies that do not represent significant risks. Accordingly, they thought that there should have been a greater emphasis in the proposed ISA on the fact that not all related party transactions represent significant risks.
5. The task force notes that the IAASB did not intend to establish a separate set of audit procedures for related parties independently of the audit risk and fraud ISAs. Rather, the intention was to develop the proposed ISA within the context of these other ISAs, without duplicating the requirements and guidance in these ISAs. However, the task force acknowledged the respondents' comments that the proposed ISA could have better reflected its relationship with these other ISAs. Accordingly, in revising the wording of the proposed ISA, the task force has tried to better reflect this (e.g. **Refer to paragraphs 1, 11, 12, 17, 19, A12 and A23 of Agenda Item J.1**).
6. The task force also agreed that the proposed ISA would give a more balanced message if it explicitly recognized that, in the majority of cases, related party transactions are routine in nature and do not give rise to significant risks. Accordingly, guidance to that effect has been added (**Refer to paragraph 2 of Agenda Item J.1**).
7. A number of the respondents noted separately that the procedures set out in paragraphs 11 and 15 of ED 550<sup>1</sup> appeared to be improperly characterized as “risk assessment”

<sup>1</sup> Paragraph 11 of ED 550 proposed to require the performance of the following risk assessment procedures specifically directed towards identifying RP relationships and transactions not identified or disclosed by management:

- (a) Inquiries of management and others within the entity about the existence of significant non-routine transactions;
- (b) Where a party appears to actively exert dominant influence over the entity, procedures intended to identify the parties to which the dominant party is related, and to understand the nature of the business relationships that these parties may have established with the entity; and

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procedures. They argued that risk assessment procedures should serve to provide the auditor with an understanding of the entity, its environment and its internal control to enable the auditor to assess the risks of material misstatement in relation to related parties, and not to identify or detect additional related party relationships or transactions. Accordingly, they suggested that these procedures should only be required as responses to assessed risks, including significant risks.

8. A respondent suggested that those audit procedures that should always be performed could be made requirements on the basis that the results of the assessment of risks cannot overcome the need to respond to the presumption that related party issues always represent a significant risk at the financial statement level.
9. The task force notes that, in developing ED 550, the IAASB had debated whether these procedures should be risk assessment procedures or mandatory responses. The IAASB had decided to classify these audit procedures as risk assessment procedures to ensure that they would always be performed regardless of the assessed risks. The IAASB had concluded that related parties should not be considered as always representing a presumed significant risk at the financial statement level because doing so would involve, even for the simplest audit, the need to implement the substantial requirements that apply for significant risks (e.g. greater use of more experienced staff and tests of controls). In addition, the IAASB had taken the view that it would be difficult for the auditor to make a presumption of significant risk upfront without the benefit of more detailed work in understanding the entity.
10. However, taking into account other specific comments from respondents on paragraph 11(a)-(c) of ED 550 (see Issues D-F), the task force proposes to revise paragraph 11 of ED 550 so that the main focus of the risk assessment procedures is now more on making inquiries of management to obtain an understanding of the entity's related party relationships and transactions (**Refer to paragraph 13 of Agenda Item J.1**). The task force proposes to add a new requirement for the auditor to remain alert throughout the audit for transactions or other information that may indicate that the information obtained from those inquiries is incomplete, and to investigate if any unidentified or undisclosed related parties or related party transactions are identified (further discussed in Issue D). The task force believes this will reinforce the need for the auditor to be looking for unidentified or undisclosed related party transactions when performing all other audit procedures, rather than being focused on the review of certain types of documents only. However, as more fully discussed in Issue F, the auditor will continue to be required to specifically review

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- (c) Review of appropriate records or documents (including, among others, bank and legal confirmations) for significant non-routine transactions and for other information that may indicate the existence of unidentified or undisclosed RP relationships or transactions.

Paragraph 15 of ED 550 proposed in the risk assessment section that the auditor shall determine whether significant non-routine related party transactions have been appropriately authorized and approved.

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bank and legal confirmations, and certain entity minutes because of their particular importance (*Refer to paragraph 16 of Agenda Item J.1*).

11. Finally, the task force agreed that the proposed requirement to obtain evidence about the authorization and approval of significant non-routine related party transactions should be reclassified as a response to assessed risk as it is more in the nature of a procedure performed to respond to identified risk. However, this procedure would be required for each significant non-routine related party transaction the auditor has identified because such a transaction, by its nature, gives rise to at least a risk of material misstatement. Accordingly, the task force proposes that for significant non-routine related party transactions identified during the audit, the auditor shall obtain evidence that they have been appropriately authorized and approved (*Refer to paragraph 21 of Agenda Item J.1*).
12. The task force believes that the proposed approach described above will provide a reasonable basis for identifying and assessing the risks of unidentified or undisclosed related party relationships and transactions, and make a clearer differentiation between risk assessment procedures and responses to identified and assessed risks.

#### Matter for Consideration by the IAASB CAG

- Q1. Do the Representatives agree that the revised wording of the proposed ISA better reflects the inter-relationship between this ISA and the audit risk and fraud ISAs, and more clearly differentiates between risk assessment procedures and responses to identified and assessed risks?

#### B) INHERENT LIMITATION IN IDENTIFYING RELATED PARTY RELATIONSHIPS AND TRANSACTIONS

13. Paragraph 4 of ED 550 indicated that, for a number of reasons, there is an inherent limitation regarding the auditor's ability to identify all related party relationships and transactions. There were a number of opposing views on exposure regarding whether such explanatory material was essential for the proposed ISA. Some respondents were of the view that highlighting the inherent limitation of the auditor's ability to identify related party relationships and transactions projected a negative message in the ISA and simply reiterated the limitations implicit in an audit. These respondents recommended that such discussion be moved to ISA 200, which deals with general concepts relevant to an audit, and that the emphasis in the proposed ISA be changed to focus more on the need for the auditor to be even more alert in this area. Other respondents took an opposing view, commenting that ED 550 gave the impression that many more undisclosed related party transactions can be expected to be brought to light. The latter group of respondents generally suggested the need for a clearer emphasis on the fact that a well-conducted audit performed in accordance with ISAs would not necessarily result in the detection of undisclosed related party transactions, especially if those transactions are intentionally hidden.

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14. Although the task force agreed that it would be appropriate to discuss the inherent limitations of an audit in a pervasive ISA such as ISA 200, the task force's view is that in this particular case, because of the risks arising from the special nature of related parties, it is important to highlight the inherent limitation in the auditor's ability to identify related party relationships and transactions in this ISA too. The task force, however, agreed to amend the wording of the explanatory material to achieve a more appropriate tone for the message (*Refer to paragraph 4 of Agenda Item J.1*).

#### Matter for Consideration by the IAASB CAG

- Q2. Do the Representatives agree that it remains appropriate to communicate the inherent limitation message, as reworded, in this particular ISA because of the special nature of related parties?

#### C) USE OF DEFINITIONS BASED ON IAS 24

15. Paragraph 7 of ED 550 proposed, for the purpose of the ISA, related party definitions based on those in IAS 24 if the applicable financial reporting framework (FRF) does not establish related party definitions and requirements. Various respondents raised the following concerns regarding the proposal:
- The proposed definitions did not cover FRFs that establish only limited (rather than no) related party requirements. This would thus result in the ISA mandating the use of more extensive related party definitions in some jurisdictions than in others. Without minimum definitions for audit purposes that would apply in all circumstances, auditors would apply the ISA inconsistently, with some interpreting the requirements broadly and others narrowly, depending on the definitions in the applicable FRF. Further, the requirement to obtain written representations would be difficult to implement satisfactorily in the absence of related party requirements in the applicable FRF, because the representations would not provide any assurance regarding related parties that are not defined in the FRF.
  - The proposed ISA appears to be used as a vehicle to compensate for perceived inadequacies in FRFs. The proposed definitions could thus be perceived as establishing requirements for management and those charged with governance through the "backdoor."
  - The proposed ISA appears to involve the consideration of IAS 24 in isolation, even though IAS 24 is cross-referenced to other IFRSs. The proposal thus seemed to contradict the IAASB's policy of promulgating framework-neutral ISAs.
  - Defaulting to the IFRS definitions would set an impracticable benchmark in some circumstances, particularly in jurisdictions where government and state-owned enterprises play a significant role in the operations of many entities, such as in China.

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Consequently, it is difficult for management or the auditor in such jurisdictions to identify what is under “common control” or “influence.”

- In jurisdictions where the definitions in the FRF are less comprehensive than those in IAS 24, management might not have established the necessary accounting systems to identify related party relationships and transactions as defined by IAS 24.
  - There are very few FRFs that do not deal with related parties at all, although many deal with them at a very high level. Accordingly, establishing the proposed definitions for the purposes of the ISA would appear to be an unnecessary complication.
16. Two respondents suggested that, instead of establishing a rigid set of definitions for those circumstances where the FRF has no related party requirements, the proposed ISA should provide guidelines regarding the meaning of a related party to which the auditor could refer when applying the requirements of the ISA (similar to the approach adopted in the proposed revised ISA 320 for the definition of materiality).
17. After considering the possibility of establishing a minimum definition that should be applied in all circumstances, the task force came to the view that this would probably be going too far and could appear to be a somewhat heavy-handed approach to address what should be a minority of situations. Instead, the task force agreed with the above suggestion that it would be preferable to provide broad guidelines regarding the meaning of a related party based on the common characteristics of related parties (**Refer to paragraph 9 of Agenda Item J.1**). This approach allows sufficient flexibility for the auditor to exercise professional judgment in interpreting these general guidelines in the entity's circumstances.
18. However, rather than limit these guidelines to situations where the FRF does not provide related party definitions or descriptions, the task force is of the view that these guidelines should be applicable regardless of the provisions of the FRF for the purpose of addressing the risks of material misstatement due to *fraud* (**Refer to paragraphs 6 and 9 of Agenda Item J.1**). The task force believes that, where the FRF has weak or no related party requirements, these guidelines would provide the appropriate context or mindset for the auditor in performing procedures relating to transactions with such parties as are covered by the guidelines, for the purpose of fulfilling the auditor's responsibilities relating to fraud. Where the FRF has related party requirements that are comparable to those of IAS 24, the task force is of the view that the guidelines proposed would not significantly extend the auditor's responsibilities relating to fraud. In addition, the task force generally agreed that these guidelines should not be extended to consideration of risks of material misstatement due to *error*, as doing so would likely imply an override of the FRF for jurisdictions that have lesser requirements, through imposing what would effectively be an ISA definition.
19. The task force, however, did not reach a final conclusion regarding whether to apply these broad guidelines to all the requirements of the ISA, or whether they should be limited to certain requirements only. The task force notes that requirements in the proposed ISA that



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pertain to financial statement *disclosures* should only be applicable by reference to related party definitions set out in the FRF. However, from a practicability standpoint, isolating these specific requirements and applying the broad guidelines to the rest of the ISA would result in a somewhat cumbersome set of requirements and guidance. On a preliminary basis, pending further discussion with the IAASB, the task force proposes that the auditor considers these guidelines only for the requirements proposed in **paragraphs 12 and 13 of Agenda Item J.1. Paragraph A6 of Agenda Item J.1** provides further explanation of how the auditor applies these guidelines in obtaining an understanding of how the entity is controlled or significantly influenced, and how it controls or significantly influences other related parties, for the purpose of addressing the auditor's responsibilities relating to fraud.

#### Matter for Consideration by the IAASB CAG

Q3. What are the Representatives' views on the revised approach the task force has taken on this issue, i.e. to establish broad guidelines to describe the meaning of a related party for the purpose of addressing the risks of material misstatement due to fraud?

#### D) SIGNIFICANT NON-ROUTINE TRANSACTIONS

20. Paragraph 11<sup>1</sup> of ED 550 proposed the performance of certain procedures directed towards *significant non-routine transactions* to identify previously unidentified or undisclosed related party relationships and transactions.
21. A number of respondents expressed concerns regarding this approach. Some felt that there would be practical difficulties in inquiring of management regarding such types of transactions because, in the absence of an agreed definition, management would have its own interpretation of the meaning of the phrase "significant non-routine." It was also argued that the requirement seemed to cast a very wide net in the search for unidentified or undisclosed related party relationships and transactions, which might not be cost effective. Further, it was noted that the focus on significant non-routine transactions seemed to ignore unidentified or undisclosed *routine* related party transactions.
22. Some of the respondents suggested the following alternative approaches:
  - As ISA 315 requires the auditor to consider significant non-routine transactions in determining those risks that require special audit consideration, the consideration of the involvement of related parties in significant non-routine transactions could be related to those transactions identified as a result of the procedures applied in accordance with ISA 315.
  - Rather than focusing on the characteristics of significance and level of routine, the auditor could focus on those characteristics of transactions that might be indicative of the existence of related parties, for example, terms that do not appear to be at arm's length.

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23. In view of the practical concerns raised, the task force proposes that the requirement in subparagraph 11(a) of ED 550 be deleted. The task force agreed with the suggestion above that, rather than focusing on the characteristics of significance and level of routine, the proposed ISA could focus on those characteristics of transactions that may be indicative of the existence of related parties. Consequently, the task force proposes to replace the original requirement with a more general requirement for the auditor to be alert for transactions or other information that may be indicative of the existence of unidentified or undisclosed related party relationships or transactions (**Refer to Paragraph 16 of Agenda Item J.1**) (see also further discussion in Issues A and F below). In addition, the task force proposes guidance to describe some of the characteristics of transactions that may be indicative of the existence of related parties (**Refer to Paragraph A18 of Agenda Item J.1**).
24. Paragraph A4 of ED 550 stated that significant transactions involving management or those charged with governance, or third parties related to them, are non-routine because of the nature of the related party relationships. It also stated that transactions may be regarded as significant where they appear to be significant to the related parties even though not material to the entity.
25. Some respondents questioned the practicability of the auditor making a determination as to whether transactions are significant to the related parties even though not material to the entity. They noted that it would be difficult for the auditor to fairly determine what is significant from the related parties' perspective. Further, they argued that the auditor's focus should be on material items, and materiality should be determined in the context of the entity's financial statements and not its related parties. They also questioned whether significant transactions involving management or those charged with governance should be non-routine by definition, as they believed some of these transactions could well be conducted in the normal course of business.
26. The task force accepted these comments and proposes that the related guidance be deleted.

#### Matters for Consideration by the IAASB CAG

- Q4. Do the Representatives agree that the proposed requirement for the auditor to inquire about the existence of significant non-routine transactions should be revised as discussed above?
- Q5. Do the Representatives agree that the guidance in paragraph A4 of ED 550 should be deleted as discussed above?

#### E) DOMINANT PARTY

27. ED 550 proposed that where a party appears to actively exert dominant influence over the entity, the auditor shall perform procedures intended to identify the parties to which the dominant party is related, and understand the nature of the business relationships that these parties may have established with the entity (ED 550, paragraph 11(b)).



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28. Nine respondents specifically indicated that they agreed with the proposal, although some with reservations. Other respondents, however, expressed the following concerns.
29. Many of the respondents felt that the proposal would not be consistently applied because the terms “dominant influence” and “dominant party” were undefined. They also commented that the proposed ISA did not provide guidance to illustrate the circumstances in which the auditor would identify a dominant party or dominant influence.
30. Several of the respondents were of the view that the proposal would not be workable or cost-effective because it was too open-ended. They believed it would set unrealistic expectations to require the auditor to perform unspecified procedures to identify the parties to which a dominant party is related and to understand the nature of the business relationships. Some of them also thought that the related procedures suggested in the application material (such as inquiry of the dominant party) would be impracticable, as there may be concealment and the dominant party would have no obligation to provide information to the auditor. Further, they argued that the proposal would effectively shift the primary responsibility for identifying such parties from management to the auditor.
31. Some respondents also expressed concern regarding the lack of guidance on the application of this proposal in smaller audits. Since owner-managers would likely be considered dominant parties, they believed that the proposal would be unduly burdensome for these audits.
32. A number of the respondents suggested that a more practicable approach might be to position the procedure as a response to assessed risk, as opposed to a risk assessment procedure. This is on the basis that it would be more appropriate for the auditor to assess risks arising from dominant parties and other parties related to them based on the auditor’s understanding of the entity and its internal control, and then to determine whether significant risks exist for which the procedures required in paragraph 11(b) of ED 550 would provide an appropriate response.
33. The task force notes that this requirement was proposed to enable the auditor to be more proactive in searching for unidentified or undisclosed related party relationships and transactions involving a dominant party. Given the practical issues raised by the respondents, however, the task force proposes that there be no specific requirement regarding identifying parties to which the dominant party is related. Instead, the task force proposes application guidance to highlight that the existence of a dominant party is a risk factor on its own, and to indicate that, if other risk factors are present, this may represent a significant risk (**Refer to Paragraph A24 of Agenda Item J.1**). In addition, the task force proposes revised application guidance that addresses the auditor’s response to a significant risk of material misstatement due to fraud as a result of the presence of a dominant party (**Refer to Paragraph A30 of Agenda Item J.1**). This revised guidance suggests procedures that may be appropriate in such circumstances, consistent with the direction of the original proposed requirement in subparagraph 11(b) of ED 550.

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34. Finally, to respond to concerns about a lack of guidance as to the meaning of dominant influence, the task force proposes a definition (**Refer to Paragraph 10 of Agenda Item J.1**) based on guidance in Appendix 1 of the extant ISA 240. Such a definition centers on individuals because the task force believes the exercise of dominant influence ultimately comes down to individuals. The exclusion of entities as dominant parties also avoids scoping in entities within groups (which would be appropriately audited as part of the group audits) and governmental bodies that hold ultimate control. The task force, however, does not believe that smaller entities should be specially exempted from considerations of dominant influence as the same risks may arise in such an environment.

#### Matters for Consideration by the IAASB CAG

- Q6. What are the Representatives' views regarding the revised approach to address risks arising from dominant parties?
- Q7. What are the Representatives' views regarding the proposed definition of "dominant influence?"

#### F) MANDATORY REVIEW OF RECORDS OR DOCUMENTS

35. Paragraph 11(c) of ED 550 proposed to require the auditor to review appropriate records or documents for transactions that are both significant and non-routine that may indicate the existence of previously unidentified or undisclosed related party relationships or transactions. It also proposed that this review should include a review of bank and legal confirmations, minutes of meetings of shareholders and of those charged with governance, and other relevant statutory records.
36. Several respondents disagreed with this proposal. Some noted that requiring specific records or documents to be reviewed could imply that the auditor would not need to have the same concerns for identifying related party relationships and transactions when reviewing other records or documents. It was also observed that many of the other types of records or documents listed in the application material (paragraphs A7 and A8 of ED 550) could be more helpful in identifying related party relationships and transactions than the documents listed in the requirements section. Some argued that there would be a consistency issue as bank confirmations are not standardized throughout the world. In addition, the meaning of the term "statutory records" was questioned, as some believed it could be interpreted as meaning the entity's accounting records.
37. Some respondents suggested a more principles-based approach to require the auditor to inspect those records or documents that, in the particular circumstances of the engagement, could indicate the existence of unidentified or undisclosed related party relationships and transactions. This would encourage the auditor to consider other means of obtaining relevant information. Respondents also suggested that the three specific types of documents listed in the requirements section be moved to the application material.

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38. In light of these comments, the task force reconsidered the proposed requirement. The task force generally does not agree that a requirement for the auditor to inspect records or documents that, *in the circumstances*, could indicate the existence of unidentified or undisclosed related party relationships and transactions, would be appropriate because this would be too open-ended. The task force, however, concluded that there should be a requirement for the auditor to be alert for transactions or other information that might indicate the existence of unidentified or undisclosed related party relationships and transactions when performing other audit procedures. This would appropriately place the auditor on notice for the possibility that new information on related parties might be found when performing other procedures (**Refer to Paragraph 16 of Agenda Item J.1**). Such an approach would also respond to comments from several respondents who argued that the proposed ISA should emphasize the need for the auditor to be especially alert to related party relationships and transactions, given the inherently greater scope for misstatements.
39. The task force does not agree that the proposed requirement for the auditor to review bank and legal confirmations, and minutes of meetings of shareholders and of those charged with governance, should be moved to the application material, as the auditor should always review these documents when they are available. The task force, however, proposes that the requirement to review statutory records be deleted to respond to the concern noted above. Finally, the task force has revised the guidance to indicate that the various types of records or documents listed in the application material could be inspected by the auditor in the course of performing other audit procedures (**Refer to paragraph A21 of Agenda Item J.1**).

#### Matters for Consideration by the IAASB CAG

- Q8. What are the Representatives' views regarding the revised proposal to require the auditor to be alert for transactions or other information that might indicate the existence of previously unidentified or undisclosed related party relationships and transactions?
- Q9. Do the Representatives agree that it remains appropriate to require the auditor to inspect bank and legal confirmations, and minutes of meetings of shareholders and of those charged with governance where these are available?

#### Material Presented – FOR REFERENCE PURPOSES ONLY

Agenda Item J.1                      Proposed Revised ISA 550, "Related Parties" (September 2006  
IAASB Agenda Item 7-B)

The original exposure draft and related responses are available from <http://www.ifac.org/Guidance/EXD-Details.php?EDID=0052>.

The remainder of the September 2006 IAASB meeting material is available from <http://www.ifac.org/IAASB/Meeting-BGPapers.php?MID=0076>.

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**Note from David Damant**

Members of the CAG may be aware of the fact that there were recent representations from official circles in China and Japan which have led the International Accounting Standards Board to revisit the accounting standard on Related Parties. The concern centres on the existence in certain countries of state controlled enterprises, or enterprises which are linked to other enterprises by cross shareholdings.

As I have mentioned on previous occasions, there is also the consideration that in several countries there are large family empires which are partly quoted and partly not quoted. It is possible that the consequent concerns on related party issues are concentrated on the side of accounting standards and that no especial problem arises in the case of auditing standards. Members of the CAG are however asked to consider the documentation on Related Parties for discussion in Toronto in the light of the points made here, especially those members with connections in the relevant parts of the world.