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Related Parties

M E M O R A N D U M

FROM: David Damant

DATE: 20th March 2007

RE: ISA 550, Related Parties

I draw the attention of the CAG to the following point. The matter will be discussed at the CAG meeting in New York on April 2nd and 3rd. Apart from the debate itself, the aim will be to allow those organisations and individuals that intend to reply to the February 2007 Exposure Draft on Related Parties (closing date 30th June 2007) to consider whether the point raised below has validity.

An International Standard on Auditing concerning the question of Related Parties has an interesting dimension not shared by most other ISAs. That is, looked at in one light, it runs the risk of being seen as establishing an accounting standard where the applied accounting framework does not contain a standard on accounting for Related Parties. Nevertheless the inclusion of an ISA on Related Parties is justified in that it would not be possible for the auditor to carry out an audit, in line with the Preface and ISA 200 and indeed other standards, especially on a stand back basis (in the case of a accounting framework designed to achieve a fair presentation), if note were not taken of the fact that some transactions, because they are with Related Parties, would have to be looked at explicitly and with an additional degree of skepticism. This an auditor would do in any case, even in the absence of an auditing standard: but it is better to have treatment formalized in an ISA.

In the existing ISA 550, and in the December 2005 Exposure Draft, the definition of a Related Party adopted for the purposes of audit was essentially that which is contained in IAS 24. The definition adopted in the December 2005 Exposure Draft is set out in the Appendix to that Exposure Draft, and is attached to this memorandum. However, in the February 2007 Exposure Draft (see Agenda Item B.1) the definition adopted for the purposes of audit has been changed and is set out in Paragraph 11 of the Exposure Draft. Copies of these documents are attached.

Should the Accounting Framework under which the entity operates contain an accounting standard on Related Parties which is the same as or similar to IAS 24, the comments below do not apply. However we have to consider audits which are carried out in jurisdictions where there is no accounting standard on Related Parties, or where such an accounting standard is inadequate.

In broad terms, the existence of Related Parties gives rise to two problems. The first is that inappropriate transactions with Related Parties may lead to material misstatement in the financial statements which are being audited. Both the December 2005 Exposure Draft and

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the February 2007 Exposure Draft contain a definition of Related Parties which ensures that the auditor addresses this aspect of the matter.

The second aspect of a Related Parties situation is that Related Party activities may take place which are not material to the financial statements in quantitative terms. One may take the example of a large stores group which buys certain objects from small companies which are controlled as a private matter by certain of the directors of the stores group. These directors may personally benefit very considerably by the pricing of objects sold to the stores group and we take the case where the total involved is not quantitatively material to the financial statements being audited.

Nevertheless the existence of these relationships may be qualitatively material. Were an auditor to uncover such transactions in the course of an audit it might be necessary to draw the attention of those charged with governance, or others, to the transactions in question. This might be true even in the absence of an accounting standard or an auditing standard on Related Parties. However, the change in the definition of a Related Party as between on the one hand IAS 24 and the December 2005 Exposure Draft, and on the other hand the definition in Paragraph 11 of the February 2007 Exposure Draft, draws attention to the fact that the ISA 550 now proposed will have removed from the definition of a Related Party the sections of the IAS 24 definition which explicitly deal with Related Parties which can give rise to situations as exemplified by transactions between a stores group and small companies controlled by the directors.

In the February 2007 Exposure Draft, the Explanatory Memorandum and Basis of Conclusions (see especially paragraphs 22 onwards) discusses the various aspects of this matter and why the change has been made. However, I wish to draw attention to the possibility of “political” difficulties which may arise as a result of restricting the definition of Related Parties as in the February 2007 Exposure Draft. Were the activities of a large stores group (as in the example above) to be found subsequently to be benefiting some of the directors of the group to a significant private extent, would not the question arise: - where were the auditors?

It seems to me at least possible that the public reaction would be negative if ISA 550 indicated or appeared to indicate that the auditor was not required to look at such matters, especially as the change in the definition of Related Parties appears to point in that direction.

I do not have a conclusion on this aspect of the new Exposure Draft but I believe that the CAG should debate the matter.

Note

The definition of Related Parties in ISA 24 is currently under review by the IASB. However, the proposed amendments do not affect the point made in this memorandum.

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Appendix

Appendix to December 2005 Exposure Draft—Related Party Definitions¹ when the Applicable Financial Reporting Framework does not Establish Related Party Requirements

Related party – A party is related to an entity if:

- (a) Directly, or indirectly through one or more intermediaries, the party:
 - (i) Controls, is controlled by, or is under common control with, the entity (this includes parents, subsidiaries and fellow subsidiaries);
 - (ii) Has an interest in the entity that gives it significant influence over the entity; or
 - (iii) Has joint control over the entity;
- (b) The party is an associate (as defined in IAS 28, “Investments in Associates”) of the entity;
- (c) The party is a joint venture in which the entity is a venturer (see IAS 31, “Interests in Joint Ventures”);
- (d) The party is a member of the key management personnel of the entity or its parent;
- (e) The party is a close member of the family of any individual referred to in (a) or (d);
- (f) The party is an entity that is controlled, jointly controlled or significantly influenced by, or for which significant voting power in such entity resides with, directly or indirectly, any individual referred to in (d) or (e); or
- (g) The party is a post-employment benefit plan for the benefit of employees of the entity, or of any entity that is a related party of the entity.

A related party transaction is a transfer of resources, services or obligations between related parties, regardless of whether a price is charged.

Close members of the family of an individual are those family members who may be expected to influence, or be influenced by, that individual in their dealings with the entity. They may include:

- (a) The individual’s domestic partner and children;
- (b) Children of the individual’s domestic partner; and
- (c) Dependants of the individual or the individual’s domestic partner.

¹ These definitions are based on those set out in IAS 24, “Related Party Disclosures,” extant as of December 9, 2005. For the audit of a public sector entity, the relevant related party definitions are those set out in International Public Sector Accounting Standard 20, “Related Party Disclosures,” extant as of the same date.

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Control is the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities.

Joint control is the contractually agreed sharing of control over an economic activity.

Key management personnel are those persons having authority and responsibility for planning, directing and controlling the activities of the entity, directly or indirectly, including any director (whether executive or otherwise) of that entity.

Significant influence is the power to participate in the financial and operating policy decisions of an entity, but is not control over those policies. Significant influence may be gained by share ownership, statute or agreement.