

IAASB CAG PAPER



International Federation of Accountants

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Agenda Item **B.3**

Committee: IAASB Consultative Advisory Group

Meeting Location: Basel

Meeting Date: March 3-4, 2008

Report Back—Related Parties

Objectives of Agenda Item

1. To provide a brief report back on the September 20-21, 2007 proposals of Representatives on the proposed ISA 550 (Revised and Redrafted), “Related Parties.”
2. The proposed ISA is being presented to the IAASB at its March 10-14, 2008 meeting for final approval.

September 20-21, 2007 CAG Proposals

3. Below is an extract from the minutes of the September 2007 CAG meeting¹ and an indication of how the IAASB Task Force or the IAASB responded to the Representatives’ comments.

Representatives’ Comments	Task Force/IAASB Response
GENERAL	
Mr. Cassel, reporting on behalf of the IAASB CAG Working Group, noted that the Working Group is of the view that, generally, the Task Force’s recommendations greatly improve the exposure draft.	Representatives’ comments were supportive in this area.
OBJECTIVES OF THE AUDITOR	
Mr. Cassel noted that the Working Group was of the view that an objective to conclude ((a)(II) of the proposed objective) should not precede an objective to obtain sufficient appropriate audit evidence ((b) of the proposed objective). Ms. Hillier explained that (a)(I) and (a)(II) set the parameters for the auditor’s understanding referred to in (a).	Respondents to the second exposure draft (ED) commented, and the IAASB agreed, that an objective to obtain sufficient appropriate audit evidence should not precede the obtaining of a <i>sufficient understanding</i> of the entity’s related party relationships and transactions. Irrespective of whether the applicable financial reporting framework establishes related party requirements, this understanding is necessary for the auditor to be

¹ The minutes will be approved at the March 2008 IAASB CAG meeting.

IAASB CAG PAPER

IAASB CAG Agenda (March 2008)

Agenda Item B.3

Report Back—Related Parties

Representatives' Comments	Task Force/IAASB Response
	<p>able to not only conclude whether the financial statements (insofar as they are affected by related party relationships and transactions) achieve fair presentation or are not misleading, but also recognize the existence of fraud risk factors. Recognizing the existence of fraud risk factors is important in identifying and assessing the risks of material misstatement due to fraud, which in turn affect the procedures the auditor should perform to obtain sufficient appropriate audit evidence. The objectives in the proposed final wording to be considered at the March 2008 IAASB meeting are structured accordingly to reflect this rationale.</p>
<p>Mr. Cassel noted that the Working Group questioned the deletion of the phrase “irrespective of whether the applicable financial reporting framework establishes related party requirements.” He noted that only three respondents had suggested the deletion. He was of the view that the phrase is an important reminder to the auditor.</p>	<p>This phrase has been reinstated in the proposed final wording to be considered at the March 2008 IAASB meeting.</p>
<p>Mr. Cassel noted that the Working Group was also concerned about the emphasis on fraud risks ((a)(I)), as opposed to other risks. Mr. Morris expressed a similar view. Ms. Todd McEnally was of the view that related party transactions are a major source of catastrophic fraud risk and should receive the utmost attention. Ms. Wood expressed a similar view. Ms. Hillier explained that the objectives need to be comprehensive enough to address compliance frameworks that do not contain disclosure requirements for related party relationships and transactions. In those circumstances, the auditor is primarily concerned about fraud risks. In that context, the Task Force considers it necessary to include the objective to identify fraud risk factors.</p>	<p>The IAASB believes that fraud is often facilitated by related party relationships or committed through related party transactions. As Ms. Hillier has indicated, the focus on recognizing fraud risk factors in the objectives is particularly important in those cases where the applicable financial reporting framework does not establish related party requirements.</p> <p>The link to fraud risk factors in the objectives also helps the proposed ISA achieve a tighter integration with ISA 240 (Redrafted),² which several respondents to the first ED strongly supported.</p>
<p>Mr. Scicluna questioned the reference to a</p>	<p>The Task Force supports the views expressed by</p>

² ISA 240 (Redrafted), “The Auditor’s Responsibilities Relating to Fraud in an Audit of Financial Statements.”

IAASB CAG PAPER

IAASB CAG Agenda (March 2008)

Agenda Item B.3

Report Back—Related Parties

Representatives' Comments	Task Force/IAASB Response
<p>compliance framework in (a)(II)(ii). He was of the view that it is part of a larger issue, which ought to be dealt with separately. Ms. Hillier explained that the concept of compliance frameworks is introduced in proposed ISA 200 (Revised and Redrafted) and, therefore, needs to be addressed as necessary in relevant ISAs. Based on comments on the exposure draft, the Task Force is recommending that the auditor's focus be on evaluating whether the effects of the related party relationships and transactions could cause the financial statements to be misleading. Ms. Hillier emphasized that it is not intended, nor appropriate, for the ISA to impose disclosure requirements for related party relationships and transactions when the financial reporting framework does not provide for such disclosures.</p>	<p>Ms. Hillier. The focus on compliance framework is necessary because related party relationships and transactions may, in some circumstances, cause the financial statements to be misleading even if the framework does not establish related party disclosure requirements. This provision in the objectives helps to raise the auditor's awareness in this regard.</p>
<p>Mr. Rabine asked whether the objective to conclude whether the financial statements, in so far as they are affected by related parties and related party relationships, achieve fair presentation / are not misleading is intended to go beyond the requirements of proposed ISA 700 (Redrafted).</p>	<p>During the meeting, Ms. Hillier noted that it was not intended to go beyond the requirements of proposed ISA 700 (Redrafted).</p>
<p>Ms. Sucher was of the view that the objectives could be more "outcomes based." She preferred objectives that start with "to determine whether" rather than "to obtain an understanding" / "to obtain sufficient appropriate audit evidence" She noted that the objective could focus more on related party relationships and transactions. Ms. Hillier noted that Ms. Sucher's comments have implications beyond the particular ISA.</p>	<p>The Task Force and the IAASB are of the view that the objectives are appropriately outcome-based in that they focus on:</p> <ul style="list-style-type: none"> - <i>Concluding</i> whether the financial statements, insofar as they are affected by related party relationships and transactions, achieve fair presentation/are not misleading. - <i>Obtaining sufficient appropriate audit evidence</i> about whether related party relationships and transactions have been appropriately identified, accounted for and disclosed in accordance with the framework. <p>In addition, the link to fraud risk factors helps feed the outcome of the auditor's risk assessment</p>

IAASB CAG PAPER

IAASB CAG Agenda (March 2008)

Agenda Item B.3

Report Back—Related Parties

Representatives' Comments	Task Force/IAASB Response
	procedures into the auditor's identification and assessment of the risks of material misstatement due to fraud.
PARTIES UNDER COMMON CONTROL	
<p>Mr. Scicluna was of the view that the existence of parties that are under common control increases the risks of material misstatement. He was concerned that the Task Force's recommendations do not reflect an appropriate level of focus on such relationships. Ms. Hillier explained that the proposed revised definition provides for entities that are under common control (i.e., fellow subsidiaries). Where the framework does not contain disclosure requirements for related party relationships and transactions, it may be an impracticable goal for the auditor to identify the full scope of parties under common control because the entity may not have the systems and practices in place to track them. In such circumstances, it would be more practicable for the auditor to obtain an understanding of the entity's organizational structure and where "active" control and significant influence exist. Once into the audit, however, the Task Force believes that it is particularly important that the auditor probes significant transactions outside the normal course of business and explicitly explore the possible effect of common control on such transactions because there may be related fraud risk factors.</p>	<p>The IAASB agreed at its December 2007 meeting that the scope of the common control part of the related party definition should not be limited to fellow subsidiaries only. This ensures that the procedures required by the proposed ISA address common control relationships more broadly.</p>
<p>Mr. Hegarty did not support the proposed revised definition. He noted that, in many developing nations, a shareholder, who is an individual as opposed to a company, may own a family of companies. This shareholder may influence the family of companies, while management of a company in the family may not be aware of another company in the family. Mr. Scicluna was of a similar view. Ms. Hillier asked what it is reasonable to expect of an auditor in an environment where management does not have the</p>	<p>See comment above.</p>

IAASB CAG PAPER

IAASB CAG Agenda (March 2008)

Agenda Item B.3

Report Back—Related Parties

Representatives' Comments	Task Force/IAASB Response
<p>responsibility to identify those relationships. She noted that this will not be an issue in circumstances when the financial reporting framework requires disclosure of such relationships and transactions, as required in most well-established frameworks, such as IFRSs. The question is how best to achieve the objectives when the financial reporting framework is a compliance framework that does not contain disclosure requirements for related party relationships and transactions.</p>	
<p>Mr. Rabine preferred a definition that closely follows the definition in International Accounting Standard (IAS) 24, "Related Party Disclosures." Ms. Hillier explained that, in the context of an IFRSs environment such as Europe, the IAS 24 definition would be the auditor's first point of reference. The definition in the proposed ISA is relevant only when the definition in the financial reporting framework is deficient.</p>	<p>Most financial reporting frameworks (including IFRS) will include the elements set out in the related party definition in the proposed ISA. Most respondents to the second ED agreed with the baseline principles-based related party definition set out in the proposed ISA. As Ms. Hillier has indicated, in jurisdictions where the framework is IFRS, the IFRS definition will apply for audit purposes.</p>
<p>Mr. Pickeur did not support the exclusion of the term "dominant influence" from the Definitions section of the exposure draft. Ms. Hillier explained that the Task Force plans to deal with the concept in the application material in the context of fraud risk factors. Ms. Sucher noted that dominant influence is the cause of recent reporting scandals and supported Mr. Pickeur's view that including the definition upfront gives important visibility to the consideration.</p>	<p>A number of respondents to the second ED were confused by the definition as it was unclear whether a dominant party is a related party. The Task Force believes that this is indeed the case because the concept of "being able to impose one's will" necessarily implies the ability to exercise control.</p> <p>The Task Force agreed that such confusion would be minimized if the description of dominant influence were moved to the application material where it can be more fully explained. This would also be appropriate given that the requirements of the proposed ISA contain only a single reference to a party with dominant influence.</p> <p>Accordingly, to give the issue appropriate visibility in the proposed final wording to be considered by the IAASB at the March 2008 meeting, the Task Force has positioned the guidance describing the nature of dominant influence towards the front of the application material in the section addressing</p>

IAASB CAG PAPER

IAASB CAG Agenda (March 2008)

Agenda Item B.3

Report Back—Related Parties

Representatives' Comments	Task Force/IAASB Response
	the definition of a related party. This guidance makes clear that a related party may be able to exert dominant influence.
ENTITIES CONTROLLED OR SIGNIFICANTLY INFLUENCED BY THE STATE	
Mr. Ju noted that, in China, the accounting standards does not regard enterprises as related to each other merely because they are controlled by the state and such enterprises are then exempted from complying with the disclosure requirements for related party relationships and transactions.	The description of common control in the proposed related party definition to be considered by the IAASB at the March 2008 meeting will exclude entities under common control by a state if those entities have <i>not</i> engaged in significant transactions or shared resources to a significant extent with one another.
IMPLICIT ARMS' LENGTH ASSERTIONS	
Mr. Hallqvist was concerned that the proposed ISA does not address the issue of transfer pricing. Mr. Ratnayake described different circumstances in which transfer pricing may occur. Ms. Hillier noted that proposed ISA deals with explicit assertions about transactions conducted at arms' length. This should address issues of transfer pricing. Also, the proposed ISA does not scope out components (as was proposed by some respondents to the exposure draft) and, as a result, should address issues of transfer pricing. Mr. Koktvedgaard cautioned that transfer pricing is often an issue of interpretation of national tax laws and government views, which are beyond the scope of the audit of financial statements.	The Task Force shares the views expressed by Ms. Hillier.
INHERENT LIMITATIONS	
Mr. Uchino noted that it is important to recognize the inherent limitations that exist in auditing related party relationships and transactions. Ms. Blomme also asked for additional guidance in this regard.	The IAASB discussed this issue at the December 2007 meeting in light of the comments received from respondents to the second ED. The IAASB concluded that no changes should be made as the discussion of inherent limitations set out in the second ED was appropriately balanced.
MATTERS TO BE TREATED AS SIGNIFICANT RISKS	

IAASB CAG PAPER

IAASB CAG Agenda (March 2008)

Agenda Item B.3

Report Back—Related Parties

Representatives' Comments	Task Force/IAASB Response
Mr. Cassel noted that the Working Group was concerned about the phrase “by default” as it is open to different interpretation by the audit and legal professions.	This phrase has been deleted in the proposed final wording to be considered by the IAASB at the March 2008 meeting.
Ms. Sucher supported the recommendation that related party transactions outside the normal course of business should continue to be treated as a significant risk. However, she was not sure about the recommendation not to classify assertions regarding arms' length transactions between related parties as a significant risk.	The IAASB concluded at the December 2007 meeting that arm's length assertions should not be treated as giving rise to significant risks by default. The IAASB, however, agreed to emphasize in the Requirements section of the ISA that there may be practical difficulties that limit the auditor's ability to obtain sufficient appropriate audit evidence that all aspects of a related party transaction are equivalent to those of an arm's length transaction.
OTHER	
Mr. Koktvedgaard was of the view that the proposed ISA appears to explain how to apply other ISAs in the context of related parties and questioned whether a separate ISA is needed.	<p>During the meeting, Ms. Hillier explained that proposed ISA 200 (Revised and Redrafted) acknowledges that the objectives in certain ISAs may be subsets of the objectives in other ISAs. An ISA on related parties has been existence for a while. It addresses an important area and provides additional requirements and guidance to the auditor in this regard.</p> <p>The Task Force shares the views expressed by Ms. Hillier.</p>
Ms. Sucher noted that the link between the proposed ISA and ISA 315 (Redrafted) and ISA 330 (Redrafted), “The Auditor's Responses to Assessed Risks” is not clear. As a result, the proposed ISA appears to require less than what is required in terms of extant ISA 550. Ms. Hiller responded that, on balance, respondents to the exposure draft were of the view that the link between the ISAs has improved.	<p>The Task Force is of the view that there is a stronger linkage between the proposed ISA and ISAs 315 and 330 in the second ED than in the first one. In addition, the proposed final wording to be discussed at the March 2008 IAASB meeting reflects a stronger risk-based approach to the audit of related party relationships and transactions compared with the extant ISA, particularly through:</p> <ul style="list-style-type: none"> • The establishment of a robust risk assessment process to identify and assess the risks associated with related parties, including:

IAASB CAG PAPER

IAASB CAG Agenda (March 2008)

Agenda Item B.3

Report Back—Related Parties

Representatives' Comments	Task Force/IAASB Response
	<ul style="list-style-type: none"> ○ A requirement to understand the controls over the authorization and approval of significant transactions and arrangements with related parties, and those that are outside the normal course of business; ○ A tighter integration with ISA 240 (Redrafted) in relation to the identification and assessment of risks of material misstatement due to fraud; and ○ A requirement to maintain a heightened state of alert to the existence of unidentified or undisclosed related party relationships or transactions throughout the audit. ● The establishment of robust responses to the assessed risks, including: <ul style="list-style-type: none"> ○ A requirement to determine whether previously unidentified or undisclosed related party relationships or transactions exist if the auditor identifies arrangements or information that suggests this possibility; ○ Additional required responses when the auditor identifies previously unidentified or undisclosed related parties or significant related party transactions; and ○ Guidance on procedures to respond to a significant risk of material misstatement due to fraud associated with a party with dominant influence. ● The provision of expanded guidance on parties with dominant influence and special purpose entities, including responses to address assessed risks of material misstatement associated these parties or entities.
<p>Mr. Pickeur was also concerned that the proposed ISA appears to be more limiting than the original exposure draft. He referred to the deletion of the</p>	<p>See comments above.</p>

IAASB CAG PAPER

IAASB CAG Agenda (March 2008)

Agenda Item B.3

Report Back—Related Parties

Representatives' Comments	Task Force/IAASB Response
requirement relating to dominant influence.	

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March 2008 IAASB Agenda Item 2, Related Parties