



**By e-mail < [EDComments@ifac.org](mailto:EDComments@ifac.org) > and by fax (0062 1 212 286 9570)**

10 May 2006

Our Ref.: C/AASC

Technical Director,  
International Auditing and Assurance Standards Board,  
International Federation of Accountants,  
545 Fifth Avenue, 14<sup>th</sup> Floor,  
New York,  
New York 10017,  
USA.

Dear Sir,

**IAASB Exposure Draft of proposed ISA 550 (Revised) on Related Parties**

The Hong Kong Institute of Certified Public Accountants is the only statutory licensing body of accountants in Hong Kong responsible for the professional training, development and regulation of the accountancy profession. We welcome the opportunity to provide you with our comments on the captioned IAASB Exposure Draft.

We support the revision of the proposed revised ISA 550 and consider that the revision of the ISA is timely given the involvement of related parties, such as directors, owners, and management, in many of the recent major corporate scandals.

We would like to highlight that certain of the proposed requirements in the revised standard will pose practical difficulties for entities incorporated in the People's Republic of China (PRC) given that the majority of entities in the PRC are still state controlled, directly and indirectly, by the PRC government through the State Council, Ministries and various other levels of government entities that exist in each province and municipality. Accordingly, we request that the practicability and the inherent limitations of the auditor being able to carry out certain of the new requirements should be carefully considered.

In addition, given that it is management's responsibilities for preparing the financial statements, it is important that the proposed standard should place appropriate emphasis on management's processes for identifying related party relationships and transactions and on the need for the auditor to obtain an understanding of such processes. Accordingly, we consider that an appropriate balance should be struck between the extent of the auditor's responsibilities and those of management, particularly when addressing situations where management has failed to appropriately identify related party relationships and transactions.

We set out in the attachment our specific comments on the proposed ISA for your consideration.



We trust that our comments are of assistance to you. If you require any clarifications on our comments, please contact the undersigned at [patricia@hkipa.org.hk](mailto:patricia@hkipa.org.hk).

Yours faithfully,

Patricia McBride  
Director, Standard Setting  
Hong Kong Institute of Certified Public Accountants

PM/SO/jc  
Encl.



**HONG KONG INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS' COMMENTS**  
**ON THE IAASB EXPOSURE DRAFT**  
**OF ISA 550 (REVISED) ON RELATED PARTIES**

**1. Specific practical difficulties facing entities incorporated in the People's Republic of China (PRC) and definition of related party in the proposed revised ISA**

We would like to take this opportunity to highlight certain issues which pose practical problems for entities incorporated in the PRC in order that these matters can be considered by the IAASB in its finalization of the exposure draft.

The majority of entities in the PRC are still controlled, directly and indirectly, by the PRC government through the State Council, Ministries and various other levels of government entities that exist in each province and municipality. The structure of these entities is not mapped out in an "organizational chart" per se, nor are there systems in place that could accurately capture the mapping of these relationships. Furthermore, the PRC Government indirectly holds interests in many entities or corporations in the PRC and overseas. Many state-owned enterprises have multi-layered structures and ownership structures that change over time as a result of transfers (which may be between government authorities) and privatization programmes. Some of these interests may, in themselves or when combined with other indirect interests, be controlling interests. However, such interests would not necessarily be known to the state-owned enterprise management or financial statement preparers. Mechanisms for control and execution are very different from other corporations around the world. Hence, the ability to identify all related state-controlled entities for certain reporting entities could be a serious practical challenge.

Furthermore, we note that where the applicable financial reporting framework establishes related party requirements, the related party definitions set out in the framework apply for the purpose of the audit. Where the applicable financial reporting framework does not establish related party requirements, the definitions set out in the Appendix of the proposed ISA applies. We advise that the proposed ISA definition goes further than the PRC accounting framework which has modified the related party definition to exclude government departments and state-owned enterprises (that would otherwise be considered related parties only due to their common control from the state).

**2. Management's processes surrounding related party relationships and transactions**

Paragraph 11 of the exposure draft establishes that material misstatements resulting from related parties often arise from management's failure (whether intentional or not) to completely identify or disclose the entity's related party relationships and transactions. In response to such risk, paragraph 11 of the exposure draft sets out the requirement for the auditor to perform a minimum set of risk assessment procedures specifically directed towards the identification and



understanding of related party relationships and transactions and to determine whether such relationships or transactions were previously identified or disclosed by management. Paragraph 4 of the exposure draft also notes that there is an inherent limitation regarding the auditor's ability to identify all related party relationships and transactions.

We agree that there is a need for the auditor to undertake appropriate risk assessment procedures in this respect. However, we are concerned that appropriate emphasis is not placed on management's processes in this respect and on the need for the auditor to obtain an understanding of such processes. As such, we recommend that the relevant paragraphs of the exposure draft be revised to:

- place greater emphasis on management's processes as a factor to be considered by the auditor when assessing the risk of material misstatement of the financial statements;
- place greater emphasis on the need for the auditor to obtain an understanding of management's processes as one of the objectives to be achieved by the auditor;
- relocate paragraph 16(a) so that it precedes paragraph 9 and expand it to describe the risk assessment procedures to be performed by the auditor in obtaining an understanding of management's process, including enquiries of management and others within the entity; and
- discuss how inadequate management processes may affect the auditor's ability to complete the audit and the related reporting implications.

In summary, we recommend that a stronger emphasis should be placed on the primary responsibility of management to ensure the quality of management's processes surrounding related party relationships and discuss how inadequate management processes may affect the auditor's ability to complete the audit and the related reporting implications.

### **3. Parties that appear to actively exert "dominant influence" over the entity**

Where a party appears to actively exert dominant influence over the entity, paragraph 11(b) requires the auditor to perform procedures designed 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. However, we are concerned that the risks that are required to be addressed and the procedures to be performed by the auditor in this respect are not clearly described in the requirements as set out in paragraph 11(b) and the discussion in the related application guidance, paragraph A6.

In particular:

- (a) "Dominant influence" and "appears to actively exert dominant influence" are not defined or explained in the exposure draft. Whilst we recognize the



difficulties in developing a precise definition for such terms, we are concerned that the absence of a definition and explanatory guidance may result in auditors developing interpretations which may be inconsistent with those developed by other auditors and/or disagreed with by management. The absence of definition and explanatory guidance of the terms “dominant influence” and “appears to actively exert dominant influence” may also result in second guessing of auditor judgements in the event of a problem arising afterwards.

As such, we recommend revision to the relevant paragraphs of the proposed standard to:

- include a definition and explanation of “dominant influence” and “appears to actively exert dominant influence” if such parties are important to consideration of related party transactions in respect of financial statements; and
  - describe situations that would lead the auditor to believe that a party may be appearing to actively exert dominant influence by using relevant terms in the standard and relating them to concepts introduced in ISA 240 “The Auditor’s Responsibility to Consider Fraud in an Audit of Financial Statements”, regarding incentives and pressures to commit fraud.
- (b) Preparation of financial statements and design and implementation of controls rests with management (and not the auditor). Management should be primarily responsible for the identification of parties exerting “dominant influence” over the entity. However, emphasis on management’s processes in this respect and on the need for the auditor to obtain an understanding of such processes is not included in the exposure draft.

Accordingly, appropriate emphasis should be placed on management’s processes and the auditor’s response thereto in this respect.

- (c) We are concerned that procedures involving appropriate background research and review of the entity’s whistle-blowing records and procedures performed during the client acceptance or continuance process as set out in paragraph A6 of the exposure draft appear somewhat open ended. In addition, those procedures may not necessarily enable the auditor to obtain a reasonable degree of comfort that such procedures will help in identifying related parties and transactions, particularly in instances where management’s processes are inadequate.

We recommend revision to the relevant paragraphs of the proposed standard to provide clearer guidance on the nature and extent of procedures the auditor is to perform to identify relevant related parties and transactions taking into consideration the responsibility of management and the inherent limitations regarding the auditor’s ability to identify all related party relationships and transactions.



- (d) Paragraph A6 of the exposure draft also requires the auditor to obtain information about a third party to which the dominant party is related and the transactions such third party may have directly or indirectly entered into with the entity. We have two key concerns. First, we believe that management should bear the primary responsibility for identifying the relevant third parties and transactions, and second, it may not be practicable for the auditor to fulfil such a requirement. As such, we recommend that this requirement be reconsidered.

In summary, we do not agree with the proposed requirement for the reasons as set above. In addition, in the redrafting process, we recommend that the practicability aspects of any new requirements be considered carefully.

#### **4. Communication with those charged with governance**

Paragraph 24(a) of the exposure draft introduces a new requirement for the auditor to communicate with those charged with governance the nature, extent, business rationale and disclosure of significant related party relationships and transactions, including those involving actual or perceived conflicts of interest.

We do not agree the auditor has a responsibility to communicate this information. It is the responsibility of management to communicate such information to those charged with governance. We would agree with the requirement in paragraph 24(b) that where there are significant issues identified during the audit, regarding the entity's related party relationships and transactions, this should be communicated to those charged with governance. Accordingly, we recommend that paragraph 24(a) is deleted from the exposure draft.

#### **5. Related parties' perspectives**

Paragraph A11 of the exposure draft states that the auditor may also seek to obtain an understanding of the business rationale of the entity's related party transactions from the related parties' perspectives.

We recognize that obtaining of an understanding of the business rationale of the related party transactions from the related parties' perspectives may help the auditor in assessing the risk of material misstatements arising from related party relationships and transactions. However, we are concerned about the practicability of the auditor obtaining such understanding. As such, we recommend that this application guidance be either removed from the exposure draft or amended to address the extent of the auditors' responsibility bearing in mind the potential risk of extending the auditor's duty of care.

#### **6. Transactions significant to the related parties and transactions of a non-routine nature**

Paragraph A4 of the exposure draft states that transactions may be regarded as significant where they appear to be significant to the related parties even though not material to the entity. As materiality is determined on the basis of the financial statements of the reporting entity rather than the entity's counterparties, we



question the practicality of the auditor making a determination of whether transactions are significant to the related parties even though they are not material to the entity from either quantitative or qualitative considerations. We believe that this is also beyond the responsibility of the auditor. We, therefore, recommend that this application guidance be deleted from the exposure draft.

Furthermore, the first sentence of paragraph A4 appears to indicate that significant transactions involving management/those charged with governance are non-routine in nature. However, it may not be always the case. For instance, sale and purchase of goods are often routine transactions for a manufacturing company even though some of such sales and purchases may be between the entity and its related parties. Accordingly, we recommend that this sentence be reconsidered.

#### **7. Completeness of the entity's related party relationships and transactions**

Paragraph A1 of the exposure draft states that inquiry of management enables the auditor to gather a complete and up-to-date list of the entity's related parties, and information on the nature of the transactions the entity has entered into with these parties. Paragraph A2 recognizes that "some circumstances may make it difficult for the auditor to obtain a full understanding of the nature of the related party relationships". These two paragraphs do not appear to be consistent with each other.

~ END ~