



**By e-mail < [Edcomments@ifac.org](mailto:Edcomments@ifac.org) >**

17 July 2007

Our Ref.: C/AASC

Executive Director, Professional Standards  
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 \(Revised and Redrafted\) \*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. The HKICPA sets auditing and assurance standards, ethical standards and financial reporting standards in Hong Kong. We welcome the opportunity to provide you with our comments on the captioned IAASB Exposure Draft.

Before we comment on the subject IAASB Exposure Draft, we would like to take this opportunity to reiterate a point made by us in our submission dated 28 March 2006 on the IAASB Exposure Draft on Improving the Clarity of IAASB Standards. We are of the view that the IAASB should approach the development of the objectives of each ISA together rather than on a piecemeal ISA-by-ISA basis as it works through the clarity project. Accordingly, we strongly recommend that the IAASB commences to look at the objectives in all ISAs and link them to the objective in ISA 200 "Objective and General Principles Governing an Audit of Financial Statements".

Notwithstanding our above comment, we support the proposed revised and redrafted ISA and consider that generally the objective to be achieved by the auditor, as stated in the proposed revised and redrafted ISA, is appropriate. Furthermore, the criteria identified by the IAASB for determining a requirement has been applied appropriately and consistently such that the resulting requirements will promote consistency and the use of professional judgement by auditors. However, we have some comments for the IAASB's consideration as set out in the attachment, in particular that the definition of related party in the proposed ISA should be aligned with the definition of a related party in the IASB Exposure Draft Proposed Amendments to IAS 24 *Related Party Disclosures – State-controlled Entities and the Definition of a Related Party*.

We trust that our comments are of assistance to you. If you require any clarifications on our comments, please do not hesitate to contact me or Steve Ong, Deputy Director, Standard Setting ([ong@hkicpa.org.hk](mailto:ong@hkicpa.org.hk)).

Yours faithfully,

Patricia McBride  
Executive Director

PM/SO/jc  
Encl.



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

**Request for Specific Comments**

**1. Is the definition of a related party, stated in the proposed revised and redrafted ISA, appropriate?**

Overall, we agree with the principles based approach to the requirements of the proposed ISA, in particular where the financial reporting framework does not define a related party and management will not have designed and implemented an information system that would adequately identify related party relationships and transactions. However, we have concerns about the proposals for reporting entities that are controlled or significantly influenced by a state or are controlled or significantly influenced by a common shareholder.

The cost of meeting the requirements in the proposed ISA for entities controlled or significantly influenced by the state is not always offset by the benefit of increased information for users of financial statements. Eliminating requirements that produce information that is often of high volume and little value will therefore enable auditors, preparers and users of financial statements to focus on those related party relationships that are likely to affect the financial statements.

We note that International Accounting Standards Board Exposure Draft of *Proposed Amendments to IAS 24 Related Party Disclosures – State-controlled Entities and the Definition of a Related Party* proposes that reporting entities that are controlled or significantly influenced by a state are exempted from the disclosure requirements of IAS 24 in relation to transactions with other entities controlled or significantly influenced by that state where there are no indicators that the reporting entity influenced, or was influenced by, that entity.

We anticipate that requirement in the proposed ISA may cause difficulties in China where China has already modified the related party definition in its financial reporting framework to exclude government departments and state-owned enterprises that are under common control from the state.

Furthermore, it is not uncommon for the management of a reporting entity to be in a position where it is not able to know the other investments of a dominant shareholder, especially if such information is not required in its financial reporting framework. The coverage of related party could be quite extensive for a dominant shareholder with many investments especially if it involves close family members of the dominant shareholder. It would certainly impose additional costs for the reporting entity in gathering such information, even if such information were readily available.

Given the above, we are of the view that the definition of related party in the proposed ISA and that of IAS 24 should be aligned. We therefore recommend that in the definition of related party in the proposed ISA, exemption should be given to reporting entities that are controlled or significantly influenced by the state or controlled or influenced by a dominant shareholder with other entities that are controlled or significantly influenced by that state or dominant shareholder where there are no indicators that the reporting entity influenced or was influenced by, that entity as related party.

**2. Should the proposed revised and redrafted ISA address the auditing implications of implicit arms length assertions that management has made for related party transactions?**

We do not agree with including guidance in the proposed ISA to address the auditing implications of implicit arms length assertions on related party transactions. The ISAs are sufficient to guide the auditor to undertake the appropriate procedures and actions in the circumstances of the applicable financial reporting framework. The ISAs should not address a framework-specific requirement.

**Other Comments**

**3. Risk Assessment Procedures and Related Activities**

We note that in paragraph 19 of the proposed ISA, the auditor is required to inspect bank and legal confirmations and minutes of meeting for information which may indicate the existence of related party relationships or transactions. In paragraphs A18 and A19 of the Application Material, the IAASB lists out additional transactions or documents the auditors may review at their discretion which may indicate related party relationships or transactions.

The proposed ISA however fails to explain the rationale for only listing two documents as requirements and the others as optional. If the intention of the IAASB is to list documents which must be reviewed in all circumstances in the requirements section and those which are reviewed only when available in the Application Material, we are of the view that the seventh bullet in A19 “specific significant contracts and agreements not in the ordinary course of business, including those involving management and those charged with governance” should be included in the requirements section.

In addition, some comparison of identified related parties with those of previous years would also help to identify any missing or new relationships and transactions.

We therefore recommend the IAASB to reconsider the list of documents to be reviewed by auditor in terms of which should be reviewed in all circumstances.

**4. Arms Length Transaction as a Significant Risk**

We disagree with the requirement in second bullet of paragraph 21 of the proposed ISA that states that where management has made an assertion in the financial statements that a related party transaction was conducted on terms equivalent or similar to those prevailing in an arms length or market transaction, the auditor shall treat that as circumstances giving rise to significant risk.

Though, by nature, related party transactions have higher inherent risk; it does not mean that inherent risks are significant risks. ISA 315 (Redrafted) *Identifying and Assessing the Risk of Material Misstatement Through Understanding the Entity and Its Environment* defines significant risk as “an identified and assessed risk of material misstatement that, in the auditor’s judgement, requires special audit consideration” and asks the auditor to consider “whether the risk involves significant transactions with related parties” is a significant risk. In the Application Material, it is further explained that significant risks often relate to significant non-routine transactions or judgemental matters. Routine, non-complex transactions that are subject to systematic processing are less likely to give rise to significant risks. It is clear from ISA 315 (Redrafted) that it is not suggesting that all related party transactions are significant risks. ISA 315 leaves the determination of significant risks to the discretion and professional judgement of the auditor as it also includes other factors. Thus, consistent with the ISAs, the auditor should assess these factors before concluding that related party transactions give rise to significant risk.

It is also evident from paragraph 2 of the proposed ISA that many related party transactions are in the normal course of business and in such circumstances, they may carry no higher risk of material misstatement of the financial statements than similar transactions with unrelated parties. However, the requirement in paragraph 21 seems to contradict this understanding.

Moreover, in paragraph A22 of the Application Material, the IAASB has identified that there will be practical difficulties that limit the auditor in obtaining evidence that all aspects of the transaction are equivalent or similar to those of an arms length or market transaction. We question the purpose of setting a requirement which the auditor will have practical difficulties in meeting.

We therefore recommend that the IAASB focus the requirement on significant related party transactions with related parties that are outside the normal course of business and delete the second bullet.

## **5. Related party's perspective**

We note that the paragraph A11 in the extant exposure draft has been amended to apply to significant related party transactions outside the normal course of business as stated in paragraph A30 of the proposed ISA. Paragraph A30 of the proposed ISA states that the auditor may also seek to obtain an understanding of the business rationale of the non-routine transaction from the related party's perspective.

In our submission dated 10 May 2006 on the IAASB Exposure Draft of proposed ISA 550 (Revised) on Related Parties, we raised concerns about the practicability of the auditor obtaining such understanding.

We therefore recommend that this application guidance be deleted 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. Special purpose entities**

We note that the proposed ISA made brief reference to special purpose entities in paragraphs A8 and A18. We are of the view that there is insufficient guidance for auditors to enable an understanding of such entities and the circumstances in which they may be related parties. The use of special purpose entities is not rare and accordingly, we proposed that further guidance be provided in the ISA in this regard.

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