



Guidance Notes

Ultimate Controlling Party Disclosures under Generally Accepted Accounting Principles and Practice and Generally Accepted Auditing Standards

TECH 01/12

These Guidance Notes are being issued by the Malta Institute of Accountants (MIA) on 20 September 2012 to assist Members in complying with the relevant requirements in Generally Accepted Accounting Principles and Practice (GAAP) and in Generally Accepted Auditing Standards (GAAS), both defined in the Accountancy Profession (Accounting and Auditing Standards) Regulations issued in terms of the Accountancy Profession Act (Chapter 281 of the Laws of Malta), namely the requirements to be found in International Accounting Standard (IAS) 24, Related Party Disclosures, and the requirements to be found in International Standard on Auditing (ISA) 705, Modifications to the Opinion in the Independent Auditor's Report.

IAS 24 requires an entity to disclose, amongst others, the identity of the ultimate controlling party. ISA 705 on the other hand requires an auditor to give such disclosure in the auditor's report when this has not been given in the entity's IFRS financial statements.

The MIA issued guidance in 2006 (TECH 01/06) to set out an accountant's and auditor's professional obligations in relation to IAS 24. TECH 01/06 has been withdrawn by the Institute on 14 December 2011 and the guidance that was to be found therein has been replaced in two phases. As an interim phase, the Institute published TECH 02/11 on 14 December 2011. The second phase is being completed by virtue of this Technical Pronouncement. This Guidance Note is intended to assist Members in applying and complying with the identified provisions in IAS 24 and ISA 705 in the context of locally applicable relevant legislation. As of the date of this Technical Pronouncement, TECH 02/11 is being withdrawn.

These Guidance Notes are only intended to provide practical guidance to Members and are not, and should not be interpreted as, a substitute to any legislation, ISA, IFRS, IFRIC Interpretation or parts thereof. These Guidance Notes should be read in conjunction with the relevant legislation and standards. The Malta Institute of Accountants shall not be responsible for any loss sustained by any person who relies on this publication.

These Guidance Notes are applicable to financial statements for which International Accounting Standard 24 Related Party Disclosures (revised 2009) has become applicable.

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Introduction

1. International Accounting Standard 24 (IAS 24) *Related Party Disclosures* revised in 2009 and applicable for annual periods beginning on or after 1 January 2011, as well as its predecessor version revised in 2003, require an entity to disclose the name of its parent and, if different, the ultimate controlling party, which may be a commercial partnership, an individual, or individuals acting in concert, amongst others, irrespective of whether there have been any transactions between the entity and the said parties (IAS 24, paragraph 13).
2. Following the 2003 amendments to IAS 24 which became applicable for periods beginning on or after 1 January 2005, the MIA issued guidance in 2006 (TECH 01/06) to set out an accountant's and auditor's professional obligations in relation to IAS 24. TECH 01/06 was withdrawn on 14 December 2011, when the MIA published interim guidance TECH 02/11. As of the date of this pronouncement, TECH 02/11 is being repealed.
3. International Standards on Auditing (ISAs) have been recently clarified, whereby all ISAs have been re-drafted or revised in the process, as a result of which, the requirements that an auditor must satisfy in the event of missing disclosures in the financial statements have also been revised. Paragraph 19(c) of ISA 705 ('ISA 705.19(c)') in fact now states that, if there is a material misstatement in the financial statements that relates to the non-disclosure of information required to be disclosed, the auditor shall, unless prohibited by law or regulation, include the omitted disclosures, provided it is practicable to do so and the auditor has obtained sufficient appropriate audit evidence about the omitted information.

Applicability of relevant professional standards

4. An auditor is bound, under Article 179 of the Companies Act, to report to the company's members on all annual accounts of which copies are laid before the company in a general meeting. The auditor's report shall be drawn up in accordance with generally accepted auditing standards (ISAs) and the auditor shall state in the auditor's report whether, in his/her opinion, the annual accounts have been properly prepared in accordance with the provisions of the Companies Act and in particular whether the accounts give a true and fair view. In this regard, unless an entity is eligible, and elects, to apply the General Accounting Principles for Smaller Entities ('GAPSE'), all the requirements of IFRSs as adopted by the EU¹ have to be complied with, and IAS 24 is no exception.
5. The responsibility for the preparation of financial statements in compliance with IFRSs as adopted by the EU rests with management who are therefore responsible for providing the necessary disclosures for the financial statements.
6. When an entity is eligible, and elects, to apply GAPSE, disclosure of the identity of the ultimate controlling party is not required. Therefore, if such disclosure has not been given in an entity's GAPSE financial statements, the auditor need not include the identity of the ultimate controlling party in his/her auditor's report and the requirements of ISA 705.19(c) would not apply, unless there are other missing disclosures which would require inclusion in the auditor's report. IAS 24.18 requires directors to disclose any related party transactions, related party balances and the

¹ Relevant MIA Publication: Information Paper TECH01/09 *Accountancy Profession Accounting and Auditing Standards Regulations, 2009*

prevailing terms and conditions, any provision for doubtful debts in respect of related party balances, and the expense recognised for the period in respect of bad or doubtful debts due from related parties. IAS 24.19 requires such disclosures to be made under the different categories of related parties. When an entity is eligible, and elects, to apply GAPSE, transactions with the ultimate controlling party shall be disclosed in aggregate with other related party transactions.

7. The requirement in IAS 24.13 to disclose the name of the ultimate controlling party is dependent upon whether such party is able to control the reporting entity. Control is defined in IAS 24 as “*the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities*”. The IAS 24 definition of control therefore comprises two elements:
 - (a) the power to govern the financial and operating policies of an entity, and
 - (b) the ability to benefit from its activities.
8. In certain circumstances an entity might have no other entities or individuals that are able to exercise control over such an entity for example when the two elements establishing control are not held by one and the same party. This would be the case for instance when the ownership of an entity is held in such a manner that no entity, individual or group of individuals acting in concert would have the power to govern the financial and operating policies of an entity. In other circumstances, one entity or individual might have the power to govern the financial and operating policies of an entity but not the ability to benefit from its activities. In conclusion, when no party (entity or individual) is able to exercise control over an entity the requirements of IAS 24.13 and ISA 705.19(c), would not apply.
9. Where the controlling party is a trust, it will be necessary to consider whether the trust itself is controlled by a person or persons who might need to be disclosed as the ultimate controlling party. In certain trusts, such as discretionary trusts (also referred to as ‘pure trusts’), neither the trustee nor the beneficiary controls the trust (control as defined in IAS 24 and paragraph 7 of these guidance notes). In these kinds of trust relationships, when shares in an entity are held by a trust, there is a separation of these two elements comprising control as the trustee would typically have the power to deploy the trust assets whereas the beneficiary benefits from their deployment. In other words, the trustee would have the power to govern the financial and operating policies of the entity in question, while the beneficiary is merely entitled to the economic returns. As a result, after exercising professional judgement to all the circumstances of the case, one can reasonably conclude that, where a ‘pure trust’ holds shares in the reporting entity it would follow that, other than disclosure of the trust as a controlling party, there would be no further requirement to disclose an ultimate controlling party.
10. In certain circumstances, members might experience difficulties in determining whether the trustee or any outside parties have control over the reporting entity through the trust for the purposes of establishing its ultimate controlling party. In the case of some trusts, trustees may be acting on occasions in accordance with the wishes of the beneficiary (or any outside party). In others, the beneficiary may have the power to appoint or remove trustees in certain circumstances or the trustees may need to refer to the beneficiary (or any outside party) before doing certain things. If these matters do not interfere with the general independence of trustees, it may not be necessary to regard the existence of those rights as giving the beneficiary (or any outside party, as the case may be) control over the trustee, or the trust. However in other cases, there may be no evidence of the trustee having given independent consideration to the matters relevant to the reporting entity. These latter circumstances may point to trustees allowing outside

parties, such as beneficiaries, to exercise unrestricted control and if this is the case, then such parties would need to be disclosed as the reporting entity's ultimate controlling party. Consequently in the case of trusts, it is necessary to establish whether control exists and this question requires a careful assessment of the facts on a case-by-case basis.

Guidance and recommendations

11. This section sets out the MIA recommendations to its Members under the circumstances identified in the previous section. Under these circumstances the directors may not have given the disclosures required by IAS 24.13 in an entity's IFRS financial statements. When this is the case, IFRSs as adopted by the EU have not been complied with in full and the auditor's report will have to be modified accordingly.
12. In practice, the starting point would be for auditors, to explain to the directors that there will be a modified audit report if the directors do not give the required disclosures, in the interest of a true and fair view to be given by an entity's IFRS financial statements accompanied by an unmodified auditor's report. ISA 705.19(a) requires the auditor to discuss the non-disclosure with those charged with governance. Should the disclosures not be given in the entity's IFRS financial statements, the auditor would need to issue a modified report in accordance with ISA 705, and as required by ISA 705.19(c), the report would have to include, amongst others, the omitted disclosure of the identity of the ultimate controlling party.

Financial statements disclosures and audit reporting

13. When an entity is required to make the relevant disclosures in its IFRS financial statements, the MIA considers the following to be appropriate disclosures in relation to IAS 24.13:
 - (a) *"ABC Limited is a subsidiary of XYZ Holdings Limited of (registered office), which is controlled by Joseph Borg, who owns 75% of the issued share capital of XYZ Limited"*.
 - (b) *"ABC Limited is controlled by the Borg family, comprising Joseph Borg (Chairman) and his two sons John and Charles, who own 75% of the issued share capital and are three of the four members of the company's Board of Directors"*.
 - (c) *"ABC Limited is controlled by Joseph Borg who holds all of the issued 'A' shares of the company which, as noted in note x to these financial statements, constitute the only class of shares that confer the right to attend and vote at the company's general meetings"*.
 - (d) *"ABC plc is controlled by Joseph Borg, George Agius, and John Farrugia, who collectively own 55% of the company's issued share capital and who have entered into a private shareholders' agreement between themselves to exercise their voting rights in concert. On the strength of this shareholders' agreement, Messrs Borg, Agius and Farrugia have appointed three of the five members of the company's Board of Directors"*.

The above illustrative examples are not exhaustive and other disclosures may be required according to the prevailing circumstances.

14. ISA 705 requires the auditor to include a paragraph in the auditor's report that provides a description of the matter giving rise to the modification. The auditor shall place this paragraph

immediately before the opinion paragraph in the auditor's report and use the appropriate modification heading.

15. The MIA recommends that the following Basis for Modification paragraph should be included in the auditor's report in satisfaction of the requirement in ISA 705.19(b) which requires the auditor to describe the nature of the omitted information:

Disclosure has not been made in these financial statements of the identity of the company's ultimate controlling party as required by International Accounting Standard 24 - Related Party Disclosures.

16. ISA 705 requires the auditor to express a **qualified opinion** when the auditor concludes that a misstatement is material, but not pervasive to the financial statements. In addition to the Basis for Modification paragraph required by ISA 705 and dealt with in the preceding paragraph, an auditor will need to qualify his/her opinion paragraph. A qualified opinion should be expressed as being 'except for' the effects of the matter(s) described in the Basis for Qualified Opinion paragraph.
17. ISA 705 also requires that, when a misstatement is both material and pervasive to the financial statements, the auditor expresses an **adverse opinion**. When the auditor expresses an adverse opinion, the auditor shall state in the opinion paragraph that, in the auditor's opinion, because of the significance of the matter described in the Basis for Adverse Opinion paragraph that the financial statements have not been prepared, in all material respects, in accordance with IFRSs as adopted by the EU.
18. Whether the non-disclosure of the ultimate controlling party is material or material and pervasive is for each auditor to determine, depending on the circumstances of the case including but not limited to his/her understanding of the business rationale of the client's activities and the nature and extent of the transactions with such party. There is a rebuttable presumption that the non-disclosure of the identity of the ultimate controlling party is material and pervasive to the financial statements when the ultimate controlling party is a politically exposed person, a person in a sensitive or socially responsible position, or a person fulfilling a key public-interest role, who opts not to disclose his/her identity.
19. Two specimen auditors' reports are being annexed with these Guidance Notes to assist Members in drawing up the necessary modifications to their opinion. Nonetheless, Members are advised to familiarise themselves with the requirements of ISA 705 when expressing a modified opinion and tailor their reports accordingly.
20. In the case of a change in the ultimate controlling party during the current or comparative accounting reference periods that are being reported upon, or after the end of the reporting period but before the financial statements are approved and authorised for issue it would be appropriate to disclose the identity of both the previous and the existing ultimate controlling parties.

Glossary

Throughout these Guidance Notes, the following terms and abbreviations are used in the context of the connotations set out in this paragraph:

- (a) *Control* is defined in IAS 24 as the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities;
- (b) *Entity* or *reporting entity* means a commercial partnership as defined in the Companies Act and any other body, corporate or unincorporate, which carries on a trade or business and which is required to prepare financial statements in terms of the laws of Malta;
- (c) *IFRS financial statements* are those in which an entity makes an explicit and unreserved statement of compliance with IFRSs as adopted by the EU;
- (d) *Member* refers to a member of the Malta Institute of Accountants.

Appendix – Specimen Auditor’s Report

- Specimen 1: An auditor’s report containing a qualified opinion due to a material misstatement of the financial statements.
- Specimen 2: An auditor’s report containing an adverse opinion due to a material misstatement of the financial statements.

Specimen 1

Independent Auditors Report

To the Members of ABC Limited.

Report on the Financial Statements

We have audited the accompanying financial statements of ABC Limited, which comprise the statement of financial position as at 31 December 20X1, and the statement of comprehensive income, statement of changes in equity and statement of cash flows for the year then ended, and a summary of significant accounting policies and other explanatory information.

Directors’ Responsibility for the Financial Statements

The Directors are responsible for the preparation of financial statements that give a true and fair view in accordance with International Financial Reporting Standards (IFRSs) as adopted by the EU and the requirements of the Maltese Companies Act, 1995, and for such internal control as the directors determine necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor’s Responsibility

Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with International Standards on Auditing. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor’s judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity’s preparation of financial statements that give a true and fair view in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity’s internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by the directors, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our qualified audit opinion.

Basis for Qualified Opinion

Disclosure has not been made in these financial statements of the identity of the company's ultimate controlling party as required by International Accounting Standard 24 - Related Party Disclosures.

ABC Limited is a subsidiary of XYZ Holdings Limited of (registered office), which is controlled by Joseph Borg, who owns 75% of the issued share capital of XYZ Holdings Limited.

Qualified Opinion

In our opinion, except for the effects of the matter described in the Basis for Qualified Opinion paragraph, the financial statements give a true and fair view of the financial position of ABC Limited as at 31 December 201X, and of its financial performance and its cash flows for the year then ended in accordance with IFRSs as adopted by the EU.

Report on Other Legal and Regulatory Requirements

[Form and content of this section of the auditors' report will vary depending on the nature of the auditors' other reporting responsibilities.]

[Auditors' signature]

[Date of the auditors' report]

[Auditors' address]

Specimen 2

Independent Auditors Report

To the Members of ABC Limited.

Report on the Financial Statements

We have audited the accompanying financial statements of ABC Limited, which comprise the statement of financial position as at 31 December 20X1, and the statement of comprehensive income, statement of changes in equity and statement of cash flows for the year then ended, and a summary of significant accounting policies and other explanatory information.

Directors' Responsibility for the Financial Statements

The Directors are responsible for the preparation of financial statements that give a true and fair view in accordance with International Financial Reporting Standards (IFRSs) as adopted by the EU and the requirements of the Maltese Companies Act, 1995, and for such internal control as the directors determine necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with International Standards on Auditing. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation of financial statements that give a true and fair view in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by the directors, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our adverse audit opinion.

Basis for Adverse Opinion

Disclosure has not been made in these financial statements of the identity of the company's ultimate controlling party as required by International Accounting Standard 24 - Related Party Disclosures.

ABC Limited is a subsidiary of XYZ Holdings Limited of (registered office), which is controlled by Joseph Borg, who owns 75% of the issued share capital of XYZ Holdings Limited.

Adverse Opinion

In our opinion, because of the significance of the matter discussed in the Basis for Adverse Opinion paragraph, the financial statements do not give a true and fair view of the financial position of ABC Limited as at December 31, 201X, and (of) their financial performance and their cash flows for the year then ended in accordance with IFRSs as adopted by the EU.

Report on Other Legal and Regulatory Requirements

[Form and content of this section of the auditors' report will vary depending on the nature of the auditors' other reporting responsibilities.]

[Auditors' signature]

[Date of the auditors' report]

[Auditors' address]