

# The Auditing Practices Board

Independent Regulation of the Accountancy Profession

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Dear Mary

## **FRED 25 Related Party Disclosures**

The Auditing Practices Board (APB) welcomes the opportunity to comment on the ASB's proposals to revise FRS 8 'Related Party Disclosures'. The APB notes that the Exposure Draft has been issued as part of the ASB's programme to bring about convergence between UK Accounting Standards and International Financial Reporting Standards.

The APB is fully supportive of the objective of converging UK and International Accounting Standards (IAS). We are also supportive of robust accounting standards that, where necessary, provide adequate support to auditors in seeking to ensure that financial statements provide the disclosures necessary to present a true and fair view. However, we are not supportive of convergence being achieved at the expense of the quality of the resulting accounting standards. We are of the view that the proposed revisions to FRS 8 may diminish its effectiveness.

FRS 8 was issued in 1995 at the same time as Statement of Auditing Standards (SAS) 460 'Related Parties' was issued by the APB. During 1994 and 1995 the ASB and the APB worked together, very effectively, in order to produce accounting and auditing standards, dealing with related parties, that were aligned with each other. For the APB these Standards dealt with an extremely important expectation gap issue.

The APB's press release announcing SAS 460 noted, *'In most companies related party transactions are carried out on an arms-length basis for bonafide purposes. However experience has shown that corporate structures and the operating style of management are occasionally deliberately designed to obscure related party transactions. This has been highlighted in recent reports by Inspectors appointed by the Secretary of State for Trade and Industry.'* Research carried out on behalf of the APB into the content of DTI Inspectors' Reports in the period 1971 to 1995 reveals that issues relating to related party transactions, inter-group transactions and window dressing arise in 22% of the reports (19 of 88 reports).

Subsequent research into recent major frauds, that we carried out in connection with our 1998 paper 'Fraud and Audit: Choices for Society', indicates that most material frauds involve directors or other senior management and range across all sizes of entity.

It is difficult to measure the effectiveness of accounting and auditing standards. However, the issuance of FRS 8 and SAS 460 seems to have had a marked effect on the volume of

disclosure of related party transactions in the financial statements of UK listed companies. A study published by the journal Company Reporting in its April 2000 edition reveals that in the period from 1997 to 2000 there was an upsurge in the reporting of related party transactions from a quarter of companies surveyed to over a half

Despite evidence of improved disclosure in the United Kingdom, related party transactions have featured in many recent corporate collapses such as Enron, Adelphia, Worldcom and Tyco. A recurring feature of each of these collapses has been improper behaviour on the part of directors and management, frequently involving related parties such as special purpose entities. As improper related party transactions involving directors may be indicative of an entity's involvement in accounting irregularities and of going concern difficulties it is important that such transactions be subject to proper scrutiny and disclosure.

Consequently, it is the APB's strongly held view that it is undesirable for the ASB to propose a weakening of standards on related party transactions merely to harmonise with international standards. The recent events in North America referred to above provide compelling evidence that related party disclosure standards need to be considerably strengthened.

There are many similarities between the existing requirements of FRS 8 and the proposals in FRED 25. However, the APB is of the view that the approach proposed in FRED 25 is overly focused on rules and matters of bookkeeping and is insufficiently focused on the principles underlying the need to disclose related party transactions and control relationships.

As you are aware, from 2005 all EU companies whose shares are traded on a regulated market will be required to prepare their consolidated financial statements in accordance with IAS. As the Regulation does not appear to allow any deviation from IAS, any additional requirements included in FRS 8 by the ASB will not apply to the consolidated financial statements of UK and Irish companies traded on a regulated market.

The APB urges the ASB, therefore, to make strong representations to the IASB to amend its proposals as follows:

- to include paragraphs 13A and 13B of FRED 25 relating to control disclosures;
- to require disclosure of the name of the transacting related party where separate disclosure of the transaction is required by the Accounting Standard;
- to replace the proposed objective paragraph in the Standard with one that is more principled along the lines of the objective paragraph of FRS 8;
- to restructure the definition of a related party along the lines used in FRS 8;
- to make the disclosure requirements within the Accounting Standard consistent with the definition of related party used in the Standard;
- to include the expression 'at any time during the financial period' within the definition of a related party;
- to replace the expression 'significant influence' with 'influence';
- to specify more qualitative disclosures in paragraph 14 of the Exposure Draft; and
- to remove the proposed exemption for management compensation.

In Appendix 1 of this letter we elaborate on the bullet points set out above. In Appendix 2 we provide a response to each of the questions posed by the ASB in FRED 25 and the IASB in its Exposure Draft.

We have also written separately to the IASB and enclose a copy of that letter for your information.

Yours sincerely

A handwritten signature in black ink, appearing to be 'la' or a similar stylized name.

WID Plaistowe  
Chairman

Enc.

## ***Significant concerns of the APB with respect to the proposals in FRED 25***

### Disclosure of control

Where an entity is controlled by another party, FRS 8 requires disclosure of:

- the related party relationship;
- the name of that party and, if different, that of the ultimate controlling party; and
- if the controlling party or ultimate controlling party is not known, disclosure of that fact.

By contrast the IASB proposes the removal of the existing requirement in IAS 24 to disclose related party relationships where control exists and replacing it with the disclosure of relationships between parents and subsidiaries.

The APB believes that it is in the public interest for the name of the controlling party/ultimate controlling party to be disclosed. Consequently, the APB strongly supports the additional paragraphs 13A and 13B included in FRED 25. We urge the ASB to encourage the IASB to adopt such disclosures in IAS 24. If the IASB does not adopt such disclosures then, from 2005, the consolidated financial statements of UK and Irish publicly traded companies will not be required to disclose their controlling party.

The APB notes that paragraph 117 of IAS 1 (revised) proposes disclosure of the name of the parent and the ultimate parent of the group. However, as a parent is defined (in the IASB Glossary) in terms of being an enterprise it excludes control exercised by, for example, individuals and organisations such as trusts. The APB takes the view that paragraph 13A of FRED 25 provides for more comprehensive disclosure of control relationships and therefore will be more likely to meet public expectations than the IASB's proposal.

### **Disclosure of the names of related parties**

**As stated above the APB believes that** the name of the controlling party, and **if different the** name of the ultimate controlling party, should be disclosed in the financial statements. However, it is less clear whether it is necessary for the names of transacting related parties to be disclosed. Arguably knowledge of the nature of the relationship with the related party and the effect of related party transactions provides more decision useful information to users of financial statements than knowledge of the name of the related party.

FRS 8 requires the names of transacting related parties to be disclosed but makes exemption for naming related parties where confidentiality is legitimised by law. FRS 8 also recognises that it may be desirable to aggregate the disclosure of similar transactions by type of related party.

The FRED (at paragraph 15), by contrast, does not require the naming of related parties but disclosure of related party transactions for each of the following categories of related party:

- the parent;

- entities with joint control or significant influence over the entity;
- subsidiaries;
- associates;
- joint ventures in which the entity is a venturer;
- key management personnel of the entities or its parent; and
- other related parties.

At paragraph 18 the FRED also permits the aggregation of items of a similar nature except when separate disclosure is necessary for an understanding of the effects of related party transactions on the financial statements of the entity.

Although the APB accepts that it may not be necessary for the names of transacting related parties to be disclosed it is nevertheless of the view that the name of the transacting related party should be disclosed in those circumstances where separate disclosure of the transaction is required by the Accounting Standard.

Knowing the identity of a related party is of benefit to users of financial statements insofar as it enables them to cross refer to the financial statements and other sources of information issued by the related party. This benefit is acknowledged in FRS 5 *Reporting the substance of transactions* which states '...in assessing the commercial effect of a transaction, it will be important to consider the position of all the parties to it, including their apparent expectations and motives for agreeing to its various terms.'<sup>1</sup>

### **The objective paragraph**

The objective of FRS 8 set out in paragraph 1 is a much broader and more principled objective than the proposed objective of FRED 25. The APB recommends that an objective paragraph more along the lines of that in FRS 8 replace the proposed objective which focuses too much on compliance with rules without explaining why the rules are important.

### **The definition of a related party**

Although the definition of a related party in FRED 25 is broadly similar to the definition in FRS 8 we recommend that the definition be structured more along the lines of that in FRS 8. The FRED 25 definition is a list of related parties or situations that give rise to a related party relationship which, as the ASB notes, excludes shadow directors and persons acting in concert. By contrast, in FRS 8 the principles underlying what constitutes a related party relationship are set out. This is followed by various lists providing examples of related party relationships. These lists conclude with the caveat that they are not intended to be exhaustive.

We believe that the approach in FRS 8 is superior to the approach adopted by FRED 25 because it establishes high level principles and is consequently not open to abuse through preparers asserting that disclosure of a particular relationship is not required because such a relationship does not fall within any of the specific categories in the FRED.

The disclosure categories in paragraph 15 of the FRED are not fully aligned with the categories of related party outlined in the definition in paragraph 8. We recommend that the disclosure requirements be made consistent with the definition.

The proposed definition of a related party omits to include the expression ‘at any time during the financial period’ and is consequently open to abuse to the extent that preparers may contend that disclosure is only required of transactions with those parties that were related at the year end date.

### **Use of the term significant influence**

The definition of related party includes ‘an interest in the entity that gives it significant influence over the entity’. Significant influence is defined as ‘the power to participate in the financial and operating policy decisions of an economic activity [including] but not [limited to] control or joint control over those policies’. The APB recommends that the expression ‘significant influence’ be replaced with the expression ‘influence’; which is the expression used in FRS 8. The term significant influence is used in Accounting Standards in the context of defining associated companies and we are of the view that the concept needs to be broader than that. The explanation of ‘influence’ set out in paragraph 2.5(a) (iii) and (iv) of FRS 8 provides a useful model of how the term might be explained.

### **The need to specify more qualitative disclosures**

The second sentence of paragraph 14 of the FRED which purports to set out the minimum disclosures focuses on the quantitative aspects of related party transactions but not the qualitative aspects. We believe that this is a major deficiency in the proposed requirements of the FRED. We recommend that:

- the words ‘at a minimum’ be deleted. Such wording is generally inappropriate for a bold letter paragraph and as drafted a number of disclosures contemplated in the first sentence would seem to be negated by not being included in the minimum disclosures; and
- adding to the list in the second sentence:
  - (a) the nature of the related party relationship and
  - (b) any other elements of the transaction necessary for an understanding of the financial statements. (A guidance paragraph along the lines of paragraph 22 in FRS 8 would usefully support this bold letter requirement).

### **The proposed exemption for management compensation**

The APB does not support such an exemption because it would be too readily open to abuse. Key management personnel are related parties of an entity and the principle underpinning the requirements in the FRED is that transactions with related parties should be disclosed. Exempting disclosure of management compensation in the ordinary course of an entity’s operation begs the question of what is meant by ‘ordinary course of an entity’s operation’. It may be difficult for auditors to argue that specific transactions with management were other than in the ordinary course of an entity’s operations. The recent disclosures concerning how directors were remunerated at Tyco and Adelphia illustrate the breadth of imagination that can be applied in these matters.

Establishing a precedent for exemption based on transactions carried out “in the ordinary course of an entity’s operations” could be a slippery slope leading to calls for exemption of all sorts of related party transactions. As you are aware, this approach to related party transactions was mooted in the UK in the late 1980’s but did not win support.

### Questions for respondents posed by ASB in FRED 25

Question No.	Question	Suggested Response
ASB(i)	Do you agree with the proposal to issue a new standard in the UK on related party disclosures, once the new IAS 24 is approved by the IAASB?	<p>APB supports the harmonisation of national and international accounting standards and therefore agrees, in principle, with the proposal to conform FRS 8 with IAS 24. However, a number of proposed changes to FRS 8 are of concern to the APB. These are:</p> <ul style="list-style-type: none"> <li>the removal of the requirement (in IAS 24) to disclose the name of the ultimate controlling party;</li> <li>the change in the objective of the Standard away from the 'principle' of making the disclosures necessary to draw attention to the fact that the financial position and results may have been affected by the existence of related parties towards a more 'rule' based approach to prescribe disclosures about related party relationships and transactions; and</li> <li>the risk for abuse inherent in the proposed exemption in respect of management compensation paid in the ordinary course of an entity's operations.</li> </ul>
ASB(ii)	Do you believe that the ASB should consider any transitional arrangements?	No. Transitional arrangements would be confusing.
ASB(iii)	Do you believe that an accounting standard should require disclosure of the name of a controlling party and, if different that of the ultimate controlling party? If the new IAS 24 does not require disclosure, do you believe that a new UK standard should require this disclosure as set out in paragraphs 13A and 13B of the [draft] FRS?	<p>The APB believes it is in the public interest for the name of the controlling party/ultimate controlling party to be disclosed. Consequently, the APB supports the additional paragraphs set out in the UK Standard and would urge the ASB to encourage the IASB to adopt such disclosures in IAS 24. If the IASB does not adopt such disclosures then, from 2005, the consolidated financial statements of European publicly traded companies will not be required to disclose their controlling party. The APB notes that paragraph 117 of IAS 1 (Revised) will require disclosure of the name of the parent and the</p>

		ultimate parent of the group. However, as a parent is defined (in the IASB Glossary) in terms of being an enterprise it excludes control exercised by, for example, individuals and organisations such as trusts. The APB takes the view that paragraph 13A of FRED 25 provides for more comprehensive disclosure of control relationships.
ASB(iv)	Do you believe that an accounting standard should require disclosure of the names of transacting related parties?	<p>The APB believes that the name of the controlling party, and if different the ultimate controlling party, should be disclosed in the financial statements.</p> <p>However, it is less clear whether it is necessary for the names of transacting related parties to be disclosed. Arguably, knowledge of the nature of the relationship with the related party and the effect of related party transactions provides more decision useful information for users than the name of the related party per se. FRS 8 already recognises that it is desirable to aggregate similar transactions by type of related party.</p> <p>Although, therefore, it is not necessary for the names of transacting related parties to be disclosed the APB is of the view that where separate disclosure of a transaction is necessary for the understanding of the effects of a related party transaction on the financial statements of the entity (see paragraph 18 of FRED 25) that the name of the transacting related party should be disclosed.</p> <p>A benefit of knowing the name of a related party is that it enables the user of financial statements to cross refer to the financial statements and other sources of information issued by the related party. As FRS 5 acknowledges, knowledge of how a counterparty has accounted for a transaction may provide</p>

		additional insight or corroboration to the users of financial statements.
ASB(v)	Should the definition of related parties specifically refer to shadow directors/ Should it also refer to persons acting in concert?	Although the definition need not refer specifically to these categories of related party these categories should clearly be encompassed within the general definition of what constitutes a related party.
ASB (vi)	Do you believe that an accounting standard should specify that disclosure is required of <i>material</i> related party transactions and give more guidance on materiality in the context of such transactions?	<p>The APB believes that it is unnecessary for the accounting standard to specify that disclosure is required of material related party transactions because all accounting standards are only intended to apply to material items.</p> <p>The APB would not support the retention of the guidance on materiality in respect of related party transactions presently set out in paragraph 20 of FRS 8.</p> <p>However, the APB would support the inclusion of appropriate guidance dealing with the more qualitative aspects of materiality in relation to related party transactions.</p>
ASB (vii)	Are there any other aspects of the draft standard that the ASB should request the IASB to review when finalising the revised IAS.	<p>Yes. In line with our comment above regarding the move away from the more principled approach of FRED 8 to a more prescriptive approach we would recommend changes be made to:</p> <ul style="list-style-type: none"> <li>• the objective paragraph,</li> <li>• the structuring of the definition of a related party</li> <li>• use of the term 'significant influence'; and to</li> <li>• Paragraph 14.</li> </ul> <p>The objective of FRS 8 set out in paragraph 1 is a much more high level and principled objective than the proposed objective of FRED 25. The APB recommends that an objective paragraph more along the lines of that in FRS 8 replace the proposed objective which focuses too much on compliance</p>

with rules without explaining why the rules are important.

Although the definition of a related party in FRED 25 is broadly similar to the definition in FRS 8 we recommend that the definition be structured more along the lines of that in FRS 8. The FRED 25 definition is a list of related parties or situations that give rise to a related party relationship. By contrast, in FRS 8 the principles underlying what constitutes a related party relationship are set out. This is followed by various lists providing examples of related party relationships. These lists conclude with the caveat that they are not intended to be exhaustive. We believe that this approach is superior to the approach adopted by FRED 25 because it establishes high level principles and is consequently not open to abuse through preparers asserting that disclosure of a particular relationship is not required because such a relationship does not fall within any of the specific categories in the FRED.

The categories in paragraph 15 of the FRED are not fully aligned with the definition of related party in paragraph 8. We recommend that lists of categories of related party should be consistent with each other.

The definition of related party includes 'an interest in the entity that gives it significant influence over the entity'. Significant influence is defined as 'the power to participate in the financial and operating policy decisions of an economic activity but not control or joint control over those policies. The APB recommends that the expression 'significant influence' be replaced with 'influence'. The term significant influence is used in the context of defining associated companies and we are of the view that the concept needs to be broader. The

	<p>explanation of influence set out in paragraph 2.5(a) (iii) and (iv) of FRS 8 provides a useful model of how the term might be explained.</p> <p>The proposed definition of related party omits to include the expression 'at any time during the financial period' and is consequently open to abuse to the extent that preparers may contend that disclosure is only required of transactions with those parties that were related at the year end date.</p> <p>The second sentence of paragraph 14 of the FRED which purports to set out the minimum disclosures focuses on the quantitative aspects of related party transactions but not the qualitative aspects. We believe that this is a major deficiency in the requirements of the FRED. We recommend that:</p> <ul style="list-style-type: none"> <li>• the words 'at a minimum' be deleted. Such wording is generally inappropriate for a bold letter paragraph and as drafted a number of disclosures contemplated in the first sentence would seem to be negated by not being included in the minimum disclosures;</li> <li>• adding to the list in the second sentence: <ul style="list-style-type: none"> <li>(a) the nature of the related party relationship and</li> <li>(b) any other elements of the transaction necessary for an understanding of the financial statements. (A guidance paragraph along the lines of paragraph 22 in FRS 8 would support this bold letter requirement)</li> </ul> </li> </ul>
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IASB (i)	<p data-bbox="220 1003 359 1729">Do you agree that the Standard should not require disclosure of management compensation, expense allowances and similar items paid in the ordinary course of an entity's operations (see paragraph 2)?</p> <p data-bbox="927 1003 1177 1729">"Management" and "compensation" would need to be defined, and measurement requirements for management compensation would need to be developed, if disclosure of these items were to be required. If commentators disagree with the Board's proposal, the Board would welcome suggestions on how to define "management" and "compensation".</p>	<p data-bbox="220 226 608 972">The APB does not support such an exemption because it would be too readily open to abuse. Key management personnel are related parties of an entity and the principle underpinning the requirements in the FRED is that transactions with related parties should be disclosed. Exempting disclosure of management compensation in the ordinary course of an entity's operation begs the question of what is meant by 'ordinary course of an entity's operation'. It may be difficult for auditors to argue that transactions with management were other than in the ordinary course of an entity's operations.</p> <p data-bbox="647 226 895 972">Establishing a disclosure criteria of "in the ordinary course of an entity's operations" could be a slippery slope to exemption of all sorts of related party transactions. Again "ordinary course of an entity's operation" would need to be defined. This approach to related party transactions was attempted in the UK in the late 1980's and was not supported.</p> <p data-bbox="935 226 1031 972">We do not consider these concerns to be warranted as the need for definition applies equally if the transactions are to be exempted from disclosure.</p>
IASB (ii)	Do you agree that the Standard should not require disclosure of related party transactions and outstanding balances in the separate financial statements of a parent or a	The APB does not support the proposed exemption and believes that related party disclosures should be required in the separate financial statements of a parent or wholly

	wholly owned subsidiary that are made available or published with consolidated financial statements for the group to which that entity belongs (see paragraph 3)	owned subsidiary that are published with the group's consolidated financial statements. The APB supports the reasoning of the six members of IASB who expressed a dissenting view (to the exposure draft's proposals) on this issue. However the APB would limit such disclosure to those transactions that (in the consolidated accounts) are not eliminated on consolidation.
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