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International Accounting Standards Board

This document is provided as a convenience to observers at IASB meetings, to assist them in following the Board's discussion. It does not represent an official position of the IASB. Board positions are set out in Standards.
These notes are based on the staff papers prepared for the IASB. Paragraph numbers correspond to paragraph numbers used in the IASB papers. However, because these notes are less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

Board Meeting: **19 October 2006, London**

Project: **Amendments to IAS 24 *Related Party Disclosures***

Subject: **Associates and subsidiaries of the associates significant investor (Agenda Paper 17)**

INTRODUCTION

1. During convergence discussions, the Accounting Standards Board of Japan (ASBJ) raised concerns that IAS 24 *Related Party Disclosures* does not require disclosure, in an associate's individual financial statements, of relationships and transactions between an associate and a subsidiary of that associate's significant investor.[1] The ASBJ argued that there is likely to be influence over the relationship and transactions that arise between these two entities because of the existence of a common owner.

2. When considering the Agenda Proposal in July 2006, and the relationship the ASBJ raised, the Board agreed that further work should be completed to consider whether other similar relationships should also be considered for inclusion in the definition of a related party in IAS 24.

[1] See diagram below in paragraph 15 for a pictorial description of the relationships discussed.

3. In this paper, the staff asks the Board to clarify and extend the definition of a related party transaction to ensure relationships that meet the objective of IAS 24 are disclosed.

CONCLUSIONS AND RECOMMENDATIONS

4. The staff concludes that the relationship between an associate and a subsidiary of the associate's significant investor, is a relationship that should be disclosed in both the subsidiary's, and the associate's individual financial statements. The staff further concludes that the definition of a related party in IAS 24 *already* requires the disclosure of the relationship in the *associate's* individual financial statements, however clarification should be provided to ensure that this requirement is clear. The staff does not think that IAS 24 currently requires the disclosure of this relationship in the *subsidiary's* individual financial statements. Therefore, the staff recommends IAS 24 be amended to include the requirement to disclose this relationship.

5. **The staff asks the Board to amend the following sentence in IAS 24 paragraph 9 (b) by adding the underlined words:**

   > **'A party is related to an entity if the party is an associate (as defined in IAS 28 *Investments in Associates)* of <u>either</u> the entity <u>or the entity's parent</u>'**

   Further, the staff recommends adding guidance to IAS 24 to clarify that in an associate's individual financial statements the relationships as described in Example 1 below should be disclosed. Does the Board agree?

6. **The staff also recommends the decisions reached in September regarding the relief provided to for state-controlled entities should be extended to include associates of a fellow state-controlled subsidiary. Does the Board agree?**

BACKGROUND INFORMATION

7. IAS 24 states that the objective of the standard is:

> 'to ensure that an entity's financial statements contain the disclosures necessary to draw attention to the possibility that its financial position and profit or loss may have been affected by the existence of related parties and by transactions and outstanding balances with such parties.'[2]

8. Requiring an entity to disclose related party transactions provides relevant information to users of the financial statements. The information is relevant because of the user's inherent presumption that entities will normally transact on an arms length basis. If a relationship exists between transacting entities this presumption might not hold and the relationship could impact the profit or loss and financial position of the entity. Knowledge of relationships will help users assess the risks and opportunities facing the entity, therefore, users should be made aware of the relationship and any transactions that might have taken place.

9. IAS 24 is attempting to capture these relationships. IAS 24 includes a list of relationships that meet the definition of a related party. Specifically, IAS 24 paragraph 9 states that a party is related to an entity if:

   (a) directly, or indirectly through one or more intermediaries, the party:

      (i) controls, is controlled by, or is under common control with, the entity (this includes parents, subsidiaries and fellow subsidiaries)

      (ii) has an interest in the entity that gives it significant influence over the entity, or

      (iii) has joint control over the entity;

   (b) the party is an associate (as defined in IAS 28 *Investments in Associates*) of the entity;

   (c) the party is a joint venture in which the entity is a venturer (see IAS 31 *Interests in Joint Ventures*);

[2] IAS 24 paragraph 1.

(d) the party is a member of the key management personnel of the entity or its parent;

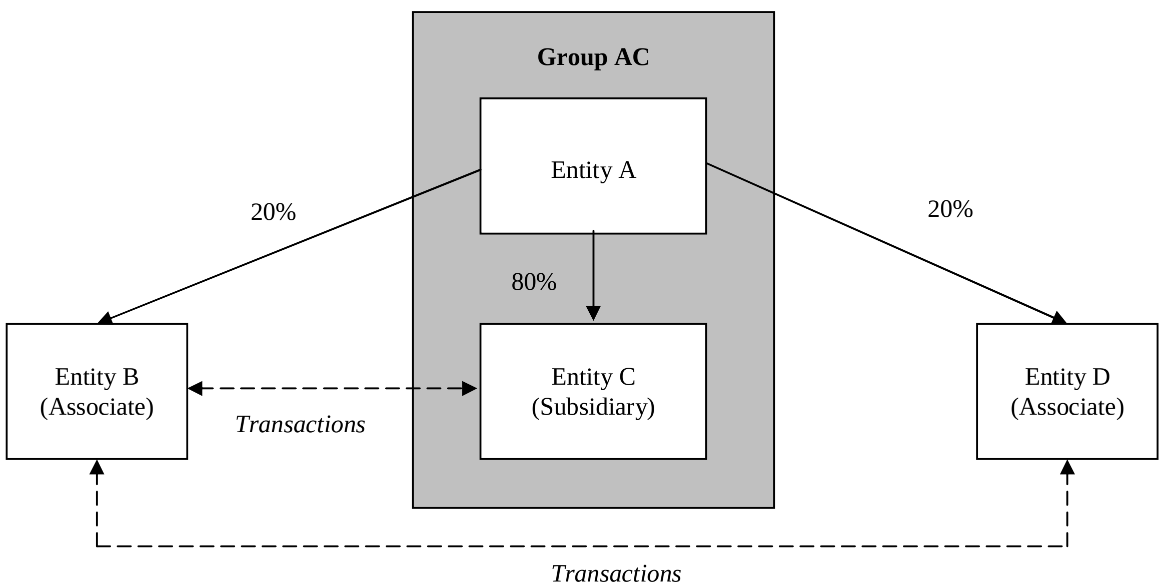
(e) the party is a close member of the family of any individual referred to in (a) or (d);

(f) the party is an entity that is controlled jointly controlled or significantly influenced by, or for which significant voting power in such entity resides with, directly or indirectly, any individual referred to in (d) or (e); or

(g) the party is a post-employment benefit plan for the benefit of employees of the entity, or of any entity that is a related party of the entity.

10. A question has been raised by the ASBJ as to whether an associate and a subsidiary of the associate's significant investor give rise to a relationship that, in the associate's individual financial statements, should be included within the definition of a related party.

11. The following diagram provides the basis of discussions in this paper.



12. During the discussion of the Agenda Proposal in July 2006, the Board indicated that the staff's analysis should include other similar situations. The diagram in paragraph 11 highlights the situations which this paper will discuss. Specifically, the paper will address the relationship between Entity B (Associate) and Entity C (Subsidiary), and the disclosure requirements in:

Example 1. **Entity B's** individual financial statements (the relationship raised by the ASBJ);

Example 2. **Entity A's** (Group AC) financial statements; and

Example 3. **Entity C's** individual financial statements.

13. The paper will then discuss the relationship between Entity B (Associate) and Entity D (Associate) and the disclosure requirements in:

Example 4. **Entity B**, **Entity D or Entity AC's** financial statements.

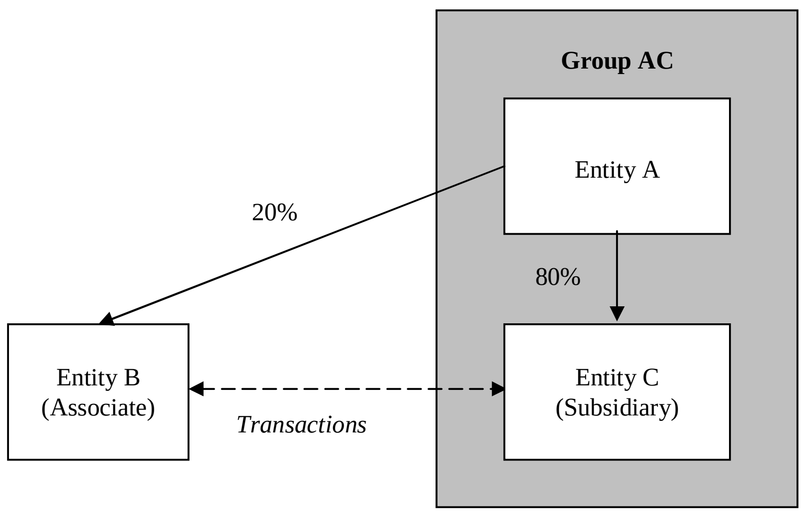
STAFF ANALYSIS

Discussion

14. When deciding whether entities should be required to disclose a relationship as a related party relationship, the starting point should be the objective of IAS 24. The ability (or perceived ability) to influence transactions and/or actions of the entity, or the ability (or perceived ability) to compel an entity to complete a transaction they otherwise would not have completed, are examples of when disclosing a relationship meets the objectives of IAS 24.

Examples 1 to 3

15. Examples 1 to 3 are depicted in the diagram below:



Example 1 - Relationship between Entity B (Associate) and Entity C (Subsidiary) and the disclosure requirements in ***Entity B's individual financial statements*** *(the ASBJ question)*

16. In this situation, Entity B is transacting with Entity C, an entity which is part of Group AC. IAS 27 *Consolidated and Separate Financial Statements* requires an entity to consolidate all subsidiaries under its control when preparing consolidated financial statements[3]. The definition of consolidated

[3] IAS 27 paragraph 9.

financial statements in IAS 27 states that they are the 'financial statements of a group presented as those of a single economic entity.'[4] The staff concludes that when considering related party transactions 'the party' will include a parent and all of its subsidiaries.

17. Group AC has significant influence over Entity B. Transactions between Entity B and its significant investor, Group AC, should be disclosed in Entity B's individual financial statements as required in accordance with IAS 24 paragraph 9 (a) (ii):

> 'A party [Group AC] is related to an entity if, directly or indirectly, through one or more intermediaries, the party [Group AC] has an interest in the entity [Entity B] that gives it significant influence over the entity [Entity B].

Group AC includes transactions that have taken place between Entity C and Entity B. Thus, the staff concludes that the standard currently requires disclosure of the transactions between Entity C and Entity B in Entity B's individual financial statements. However, the standard may not express this notion sufficiently and thus entities might not be complying with this requirement.[5]

18. Because the Board is currently amending IAS 24 for other issues, the staff thinks that this provides an opportunity to clarify the wording and the Board's intention. The staff suggests the following wording as an example to clarify the requirements of IAS 24:

> '10A In the definition of a related party, when considering the term 'party' in the context of a parent entity, it will include either the parent's separate financial statements *or* the consolidated financial statements.'

[4] IAS 27 paragraph 4.
[5] Further to this, the staff agrees that the requirement to disclose such transactions is consistent with the objective of IAS 24. The Group's ability to significantly influence the associate could impact the transactions that take place between Entity B and Entity C, and therefore the relationship and any resulting transactions should be disclosed

19. **The staff asks the Board to confirm it agrees with the staff's interpretation as noted in paragraphs 16 and 17 and that the opportunity should be taken to clarify this requirement in IAS 24.**

*Example 2 - Relationship between Entity B (Associate) and Entity C (Subsidiary) and the disclosure requirements in **Entity AC's (Group) financial statements***

20. Again, the staff thinks that IAS 24 already requires the disclosure of this relationship (see the discussion in paragraphs 16 and 17). Group AC significantly influences Entity B (IAS 24 paragraph 9 (b)), thus transactions between the Group and Entity B should be disclosed. This will include transactions between Entity B and Entity C as Entity C is part of Group AC.

21. **Again, the staff asks the Board to confirm it agrees with the staff's interpretation as noted in paragraph 20 and that the opportunity should be taken to clarify this requirement.**

*Example 3 - Relationship between Entity B (Associate) and Entity C (Subsidiary) and the disclosure requirements in **Entity C's individual financial statements***

22. Example 3 is different to Examples 1 and 2 because the reporting entity is Entity C, and not Group AC. The financial statements that are being presented are the individual financial statements of Entity C which do not include the operations of Group AC. In Example 1 and 2 the reporting entity was either Entity B that was transacting with Group AC, or it was Group AC that was transacting with Entity B.

23. The staff has concluded that IAS 24 *does not* require the disclosure of the relationship between Entity B and Entity C when Entity C's is the reporting entity. The relationship is not the same as any of those included in IAS 24 paragraph 9 (reproduced in paragraph 9 above). Entity C:

    (a) does not control (directly or indirectly) Entity B,

    (b) it is not controlled by Entity B,

    (c) it is not under common control with Entity B.

    (d) it does not itself have significant influence over Entity B,

(e) it does not have joint control over Entity B.

(f) it not a subsidiary of Entity B

(g) it is not a joint venture of Entity B.

24. Therefore, the relationship is not required to be disclosed in Entity C's individual financial statements. However, in the staff's opinion, Entity A controls Entity C, and through this control, Entity A could compel Entity C to transact with Entity B in a manner that might not be in Entity C's best interests. The existence of control is important because Entity A will benefit directly from the transactions that Entity C enters. Thus, the disclosure of the relationship and transactions between Entity C and Entity B in Entity C's accounts, in the staff's opinion, is consistent with the objective of IAS 24.

25. Further, the staff reasons that it is unusual that the relationship and transactions are not required to be disclosed in Entity C's individual financial statements, yet they are required to be disclosed in Entity B's and Group AC's financial statements. The same amount of compulsion (or perceived compulsion) to enter transactions exists in both Entity B's and Entity C's individual financial statements. Put another way, if the two entities are related in one of the entities individual financial statements then the staff conclude they should also be related in the other entities individual financial statements.

26. One possible solution to this could be to include the notion in IAS 24 that if an entity is considered to be related to another then the opposite must also apply. This would be a catch all provision to ensure relationships that should be disclosed, are disclosed.

27. The staff reason that users of the financial statements of Entity C should be made aware of the existence of the relationship and the possibility of influence.

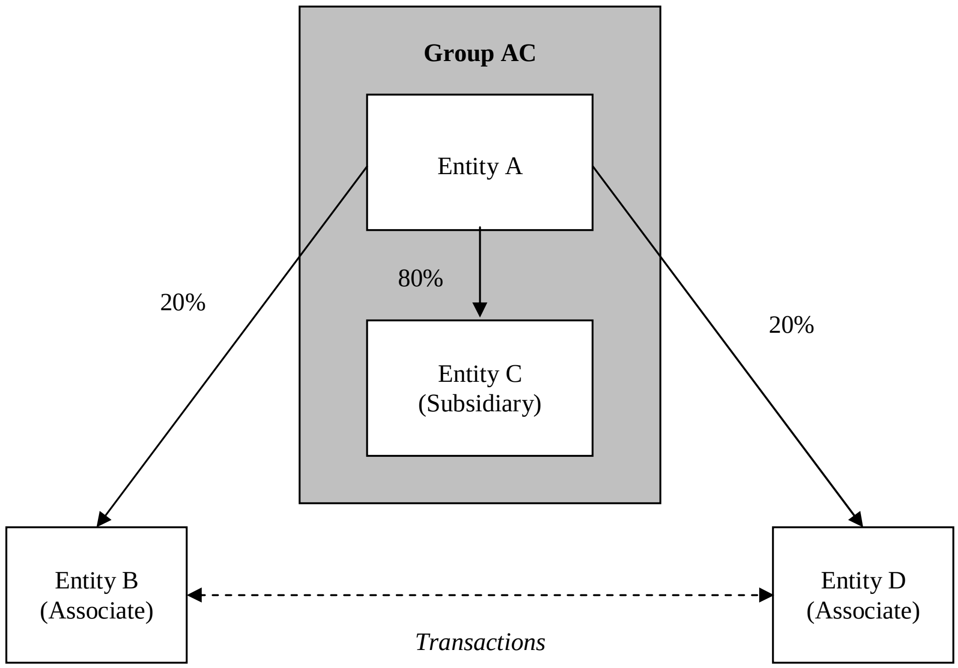
28. **The staff suggests the following amendment to IAS 24 paragraph 9 (b)**

> **'A party is related to an entity if the party is an associate (as defined in IAS 28 *Investments in Associates)* of <u>either</u> the entity <u>or the entity's parent.'</u>**

Does the Board agree with the staff's recommendation?

Example 4

29. Example 4 is depicted in the diagram below:



Example 4 - Relationship between Entity B (Associate) and Entity D (Associate) and the disclosure requirements in either Entity B, Entity D or Group AC's financial statements

30. When considering this relationship the staff thinks an important factor is the absence of control. There is common significant influence between the two entities because Entity A holds a 20% interest in both Entity B and Entity D, however, the staff does not think this is sufficient to require the disclosure of the transactions between the two entities.

31. It is not clear that the benefits arising from disclosing the relationship outweigh the costs of doing so. For example, if transactions occur on non-arms length conditions, Entity B may benefit, however Entity D is likely to be disadvantaged. Further, Group AC will only recognise its portion of the transaction and the remaining shareholders of Entity's A and B will recognise

the majority of it. Thus allowing transactions at non market rates may not be acceptable to the other majority shareholders.

32. Another argument for not requiring the disclosure of these transactions is the ability of an entity to obtain the information about associates that its significant investor holds. The ability to obtain the information is more limited than it was for an associate and a subsidiary, and in some cases an entity may not have any knowledge of the associate.

33. The staff notes however that two national standard setters do require the disclosure of such transactions. As noted in the July 2006 Agenda Proposal, Canada and New Zealand require the following disclosures requirements:

    (a) Canada – 3840 Related Party Transactions paragraph 0.04 (h) – 'Any party that is subject to significant influence…. by another party that also has significant influence over the reporting enterprise'.

    (b) New Zealand – SSAP 22 Related Party Disclosures paragraph 3.1 – 'Parties are considered to be related when they are subject to common significant influence.'[6]

34. In saying this however the staff think the arguments noted above for adding a requirement are not sufficiently compelling.

35. **The staff recommends that the Board does not include within the definition of a related party, entities with common significant influence in either of the associates, or the Group, financial statements. Does the Board agree?**

Amendments discussed in September – State-controlled entities

36. As noted at the September Board meeting, the staff indicated that the discussions from the October Agenda Paper might impact the decisions reached last month.

[6] The staff notes that New Zealand is moving to IFRS in two and a half months, therefore this standard will not apply to listed entities after that date.

37. In September, the Board agreed that relationships that meet the definition of a related party, simply because of the existence of common control from the State should initially be given relief from the disclosures of IAS 24. The staff also noted that if the Board agreed that the definition of a related party should be extended (as recommended above) the staff will consider the impact on the relief provided to state-controlled entities.

38. Because of the recommendations made in this paper, situations could arise, where an entity would not be required to disclose the transactions between itself and its fellow subsidiary, but would be required to disclose transactions between itself and the fellow subsidiary's associate. This does not appear to make logical sense.

39. **Therefore, the staff recommends to extend the relief discussed at the September meeting to include associates of a fellow subsidiary. Does the Board agree with the staff's recommendation?**