30 Cannon Street, London EC4M 6XH, United Kingdom
Phone: +44 (0)20 7246 6410 Fax: +44 (0)20 7246 6411
Email: iasb@iasb.org Website: http://www.iasb.org

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: **20 September 2006, London**

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

Subject: **Disclosure requirements for state-controlled entities (Agenda Paper 14A)**

INTRODUCTION AND BACKGROUND

1. IAS 24 *Related Party Disclosures* defines a related party relationship and details the disclosures required for transactions between an entity and a related party. Related party disclosures are an important part of financial reporting because of the effect (or perceived effect) that related party transactions can have on the profit or loss and financial position of an entity. The objective in IAS 24 highlights this by stating:

> 'The objective of this 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'[1]

[1] IAS 24 paragraph 1.

Knowledge of related party transactions, outstanding balances and relationships will help users of financial statements assess the risks and opportunities facing the entity.

2. 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*);

(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.

Any transactions between an entity and a related party must be disclosed in accordance with IAS 24 paragraph 17.

3. IFRSs are designed to apply to profit-oriented entities. The Preface to IFRSs states that the Public Sector Committee of the International Federation of Accountants (now know as the International Public Sector Accounting Standards Board) has issued a Guideline stating that IFRSs are applicable to government business entities [state-controlled entities].[2]

[2] For practical reasons the staff have initially used the term 'state-controlled entities'. This term is revisited later in the paper.

4. There is no doubt that two state-controlled entities are considered to be related parties, as defined in IAS 24. Because the State controls each of these entities they are under common control and are therefore fellow subsidiaries [IAS 24.9(a)(i)]. However, some state sectors establish their state-controlled entities to compete against each other, unlike other entities subject to common control. Many state-controlled entities can have different boards of directors with different objectives and goals, and thus, transactions between the two entities could be conducted as if they are unrelated parties. The staff thinks that in some circumstances the informational benefits associated with disclosing all transactions between fellow subsidiaries of the State will be low.

5. Some of the jurisdictions that have begun the process of adopting IFRSs have a greater number, and proportion, of government business units in their economy than the jurisdictions that already require compliance with IFRSs. In these jurisdictions, the aggregate cost of complying with IAS 24 is likely to be significant. This, of itself, does not lead to a conclusion that the costs exceed the benefits. However, an assessment of the likely costs of compliance in China, for example, warrant consideration of the likely benefits of complying with IAS 24 relative to those costs.

6. During the staff's investigations, we have become increasingly aware that this requirement is a major concern for state-controlled entities around the world, and is not confined to China. Many countries such as Germany, France, Russia and other Eastern European governments, as well as some Asian countries such as Singapore have large state-controlled entities which face similar practicality issues.

7. In jurisdictions with a large number of state-controlled entities it can be onerous to even identify other entities controlled by the State. In fact, the key management personnel of some state-controlled entities might not be able to identify other fellow subsidiaries of the State or be aware that they are transacting with a fellow subsidiary of the State. The very difficulty of even identifying fellow state-controlled entities suggests that the nature of that related party relationship might be different from that anticipated by IAS 24. An associated concern is that the disclosures can be extensive and the related party disclosures that are material to users might be obscured by related party disclosures that are not material to users.

8. At its meeting in July 2006, the Board agreed to amend the disclosure requirements in IAS 24. In providing relief the objective is to identify classes or types of related party transactions for which the costs of disclosure exceed the benefits. This paper discusses:

   (a) which types of related party transactions should be excluded from the disclosure requirements, which is also likely to be limited to a class of entities; and

   (b) what (if any) disclosures should be required as an alternative to the IAS 24 requirements.

COSTS AND BENEFITS – DISCLOSING RELATED PARTY TRANSACTIONS

9. The disclosure requirements in IAS 24 are important for an entity related to the State. Investors, other than the State, require information about related party transactions for decision making purposes. However, in jurisdictions where there are a large number of state-controlled entities there can be significant compliance costs. For example, the time spent identifying and documenting related parties and the transactions that have taken place.

10. The cost of meeting the requirements of IAS 24 for state-controlled entities, however, is not always offset with increased informational benefits for users. Extensive disclosures (in some cases a significant portion of all transactions the entity has completed) are required for transactions, which might have been conducted in a similar manner as transactions with unrelated parties. Furthermore, some state-controlled entities might not be aware that they are transacting with a fellow subsidiary of the State, thus disclosures might not be complete. When disclosures are given, the substantial amount of information provided can hide important related party disclosures.

11. It is important that relevant related party transactions are disclosed. To achieve this, the focus of any relief should be on the relationships and transactions where the costs of disclosure do outweigh the informational benefits arising from those disclosures.

12. For example, in accordance with IAS 24, an airline and the post office, both which are controlled by the State, would each meet the definition of a related

party. Suppose that no other relationship exists between the two entities, and the State does not impose any compulsion on either entity to enter transactions with each other. In accordance with IAS 24, transactions between the entities such as flights for postal staff or any postage and courier charges the airline incurs, would need to be disclosed. Further, the State owned postal service may be the only available national postal service, therefore the airline has no option but to use them. It is unclear what informational benefits are associated with these disclosures; however, the cost of determining and tracking every transaction between the two entities is likely to be high.

13. The staff thinks, that the cost of disclosing related party transactions that arise only as a consequence of the reporting entity and the related party being subject to *common control* from the State, and where the common control is not perceived to be influencing the operations of the reporting entity, is likely to outweigh the benefits for users.

Common control

14. The existence of common control from the State creates a related party relationship in accordance with IAS 24. Common control is not defined in IAS 24. Paragraph 9 (a) (i) of IAS 24 does indicate that common control means 'fellow subsidiaries'. IFRS 3 *Business Combinations* paragraphs 10 – 13 discuss business combinations involving entities under common control. Paragraph 10 of IFRS 3 states:

> 'A business combination involving entities or businesses under common control is a business combination in which all of the combining entities or businesses are *ultimately controlled by the same party* or parties both before and after the business combination, *and that control is not transitory*'.

15. By including entities subject to common control in the definition of a related party, IAS 24 makes the assumption that entities related through common control could be susceptible to influence from the controlling party and thus might not act independently of each other. In the case of entities *not* controlled by the State, the staff thinks this assumption is reasonable. In most cases, the same board of directors, who are trying to achieve the same goals and objectives for the whole group, will ultimately control these entities.

Thus, individual entities within the group could be compelled either to enter transactions they might not otherwise have entered, complete transactions at non-market rates, or do things that are they might not consider to be in their own best interests.

16. When the State is the controlling entity, the relationship between fellow subsidiaries might not create similar situations as described in paragraph 15. Over time as jurisdictions have moved from a policy of 100% owned State entities to only partial State ownership, the likelihood of influence through State ownership has decreased. Gaining synergies between two state-controlled entities is not always the State's aim when holding the controlling interest in two entities. State-controlled entities in some situations might be competing against each other. Further, the State might not have any direct daily involvement or influence over whether fellow subsidiaries transact with each other or not. Thus, the overriding *common* control is not utilised. For example, state-controlled entities often have different boards of directors and the compulsion to enter transactions might not exist. Furthermore, common State control might not affect or influence transfer pricing between entities within a group in the same way that we might expect it to influence transfer pricing in other sectors.

17. The staff concludes, for entities controlled by the State, in some circumstances, the existence of common control from the State does not give rise to situations that IAS 24 is trying to capture. There is no reason for users to consider that the existence of the State gives rise to possible influence over the entities operations. Thus, the staff proposes to provide relief from the disclosure requirements of IAS 24 to *some* entities that are related parties only as a consequence of common control from the State, if that common control is not perceived to influence the operations of the reporting entity.

Related party relationships not through common control

18. In accordance with IAS 24, other related party relationships exist through ownership interests, contract or management appointment, for example, a reporting entity's investment in a subsidiary, or an associate, or the reporting entity's relationship with its parent or key management personnel. The staff thinks that information about these relationships is just as relevant for state-

controlled entities. This is because the reporting entity is directly involved with the other party. Knowledge of the relationship and potential that the relationship could affect the transactions on balance creates the need to disclose related party transactions.

19. A related party relationship arising through common State control exists through indirect means (ie through the parent entity, the State). The reporting entity might not even be aware of the existence of the relationship, and therefore faces the extra cost of attempting to identify any fellow subsidiaries. This in itself suggests that the nature of this relationship is not what IAS 24 is attempting to capture. Moreover it is relationships where influence could give rise to impacts on the profit or loss or financial position that are material to users because entities have a direct link with related party relationships.

Conclusion

20. **The staff asks the Board to confirm that only related party relationships which arise through common control from the State should be *considered* for relief from the disclosure requirements of IAS 24. Other related party relationships, for example between entities controlled by the State and the State itself, are presumed to be material related party relationships that warrant disclosure (and are therefore not the type of relationship that the amendments are designed to provide relief from). Does the Board agree with the staff recommendation?**

21. The staff notes that *some* entities with common control from the State will be transacting in the manner that IAS 24 was aiming to capture and thus information about transactions will be important to users of the financial statements. These are discussed further below (see paragraphs 39 to 46) when the staff look to identify what any modified disclosure requirements should be.

RELIEF FOR STATE-CONTROLLED ENTITIES

State

22. The term ‘State’ refers to federal or local government. The staff considered using the term ‘State’ to indicate that the amendments will only applied to the highest level of government ie the government of a country. However, entities, for example government business entities operated by the State of California, may face similar problems as government business entities operated by the government of a country when applying IAS 24. Thus, the staff thinks that the term ‘State’ should refer to both federal and local governments[3].

23. **Does the Board agree that State should refer to both federal and local government?**

Control

24. During the agenda proposal process the Board indicated that further work needed to be completed to identify which entities should receive relief from the disclosure requirements of IAS 24. The staff began discussions with the term previously used in IAS 24 – ‘state-controlled entities’. The staff initially used this term during the agenda proposal process for practical reasons only. Prior to the Improvements project, IAS 24 originally included the following scope exemption:

> ‘No disclosure of transactions is required in financial statements of state-controlled enterprises of transactions with other state-controlled enterprises’.

25. The Basis for Conclusions in IAS 24 does not explain why the Board removed the exemption for state-controlled entities. However, the staff understands that the Board’s intention was to ensure that, where there is a related party relationship between state-controlled entities, information about the relationship and any transactions are disclosed. Such transactions were

[3] The staff note that if an entity is included within the definition of ‘State’, the entity will still need to comply with paragraph 17 of IAS 24 if it meets any of the indicators listed in paragraph 43

regarded as relevant to users and the Board did not believe the disclosure would involve undue cost.

26. Some Board members expressed concern about the use of the term ‘control’ in state-controlled entities, because they were unsure whether this was indicating the need for a 51% share holding, voting rights threshold, or control as defined in IAS 27 *Consolidated and Separate Financial Statements*. Furthermore, when discussing the State, the concept of control becomes even less clear because the State has numerous mechanisms to exhaust pressure over other entities.

27. The Board has two projects on its agenda to reconsider the definition of control.[4] The staff acknowledges that the definition of control is not clear, however, we think that any discussion of the definition of control should be dealt with in those projects. IAS 24 uses the term control as defined in IAS 27; therefore any further discussion will deal with this definition only.

28. Further to this, the staff highlight that the distinction between being controlled or not controlled by the State will not significantly impact an entities disclosure requirements, if the Board agree with the staff’s recommendations in paragraph 20. If the reporting entity is controlled by the State, the staff’s recommendation is to provide *some* entities with relief from disclosure of transactions between entities that meet the definition of fellow subsidiaries. Equally, if the reporting entity is not controlled by the State, it will not need to make any disclosures, because it is not related to subsidiaries of the State (ie the reporting entity is not a subsidiary because it is not controlled, thus it does not meet the definition of ‘fellow subsidiaries’).

Significant influence or significant ownership

29. In some situations, the State might not meet the definition of control as defined in IAS 27, however the State might clearly influence the operations of the entity. This might include the State’s power to set laws and regulations. This could also include the State’s control over the provision of services through rate-regulated mechanisms (e.g. setting of rates for electricity and other utilities). Furthermore, the State may hold what are known as ‘golden

[4] The Conceptual Framework and the Consolidations projects are considering the definition of control.

shares', which provide specific and significant protective rights to the holder. The Board asked staff to look further than using the term control to see whether any relief should be extended to include situations where the State significantly influences entities.

30. Extending the relief to included relationships and transactions where the State holds only significant influence will not have any impact on disclosure requirements if the Board agrees with the staff's recommendation in paragraph 20. Paragraphs 9 to 21 discuss which relationships should receive relief from the disclosure requirements of IAS 24. This details the staff's view that only transactions between an entity that is a related party simply because of the existence *common control* from State should receive relief from the disclosure requirements. No other transactions would be given relief.

31. IAS 24 does not require the disclosure of transactions between entities with common significant influence. Nor does it require the disclosure of transactions between two entities, one which is significantly influenced and the other which is controlled by the same investor. Thus, there is no need to include relief for these transactions.

32. Further, the staff does not propose that other transactions, such as those between the reporting entity (one significantly influenced or controlled by the State) and the State, the reporting entity and its own subsidiaries or associate investments, should be exempt from the disclosure requirements of IAS 24.

33. Therefore, the staff thinks it is *unnecessary* to include entities with significant influence from the State in any relief from disclosure requirements in IAS 24.

34. As an extension of the discussion regarding significant influence, the staff had initially considered using the term 'entities with significant State ownership'. On further consideration, the staff thinks this would create a new term that will need to be defined and could be subject to interpretation. Either the term could create a different level of influence (ie not control or significant influence) over an entity, or it could indicate something very similar to control, or significant influence.

35. If the term 'entities with significant State ownership' creates a third level of influence the staff thinks this could pre-empt the discussions from projects

working on the definition of control, ie an attempt to extend the definition of control. Furthermore, if using the term ‘entities with significant State ownership’ results in including entities that in reality meet the current definitions of control or significant influence the staff then argue that there is no need to include a different term.

36. IAS 24 includes a definition of control and a definition of significant influence.[5,6] These definitions are the same as the definitions included in IAS 27 and IAS 28 *Accounting for Associates* respectively. A number of the requirements in IAS 24 for determining when a related party relationship exists are based around when control or significant influence exists. Thus, the staff thinks that the use of the term control when providing relief to the requirements is the logical direction to take.

Conclusion

37. **Does the Board agree that any relief provided by amendments to IAS 24 should be limited only to those entities that meet the definition of a related party simply because of common control from the State? Does the Board agree that relief should not include entities that are significantly influenced by the State?**

38. The staff notes that the full project to amend IAS 24 will focus on two main issues. The second part of amendments to IAS 24 will apply to *all* entities using IFRS and not just state-controlled entities. It will include a possible expansion of the definition of a related party to include relationships between an associate and a subsidiary of the associates significant investor (ie entities with common investors with either significant influence or control). The staff will bring a paper back to the Board if decisions made in the second part of the project influence the decisions made in this paper.

39. The staff’s initial thought, if the extension of the definition of related parties is made in the second phase of the project, is to widen the relief in the first phase

[5] IAS 24 paragraph 9 states significant influence is the power to participate in the financial and operating policy decisions of an entity, but is not control over those policies. Significant influence may be gained by share ownership, statute or agreement’

[6] IAS 24 paragraph 9 states control is the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities.

of the project for state-controlled entities to include both entities controlled and significantly influenced by the State.

WHAT WILL THE RELIEF BE?

Existing presumptions

40. To clarify – the staff have recommended the following:

    (a) Only related party relationships where entities share common control from the State should be *considered* to obtain relief from the disclosure requirements of IAS 24. Other related party relationships, for example between entities controlled by the State and the State itself, are presumed to be material related party relationships that warrant disclosure (and are therefore not the type of relationship that the amendments are designed to provide relief from).

    (b) Any relief provided by amendments to IAS 24 should be limited only to those entities that meet the definition of a related party simply because of common control from the State, and that common control is not perceived to be creating any influence over the reporting entity. Relief should not include entities that are significantly influenced by the State.

    Based on these two recommendations, the staff will discuss what the relief will be, and what disclosures (if any) entities will make instead of the IAS 24 disclosures.

41. The staff thinks that in some situations common control from the State could give rise to relationships that should be disclosed. Recall the example of an airline company and the post office, which are both direct subsidiaries of the State. The staff is satisfied that the initial situation described in paragraph 12 should obtain relief from the disclosures of IAS 24. However consider the following situation. The State might require a discounted rate to be paid for mail that is sent by air freight, or the post office might be compelled to use only the state-controlled airline for all of its air freight (even if transactions are at market rates). In these situations, influence from the common controller is impacting transactions entered into by the reporting entity. The staff reason that these transactions should be disclosed as they are important to users of the financial statements.

42. The difficulty is determining which related parties should be required to make the disclosure requirements in IAS 24 without creating bright lines.

43. Relief should be provided only to those relationships, where the cost of compliance exceeds the informational benefits. These situations could arise when the reporting entity is unaware that either the relationship exists or that transactions are occurring. They will also arise when an entity is aware of the existence of common State control, but the existence of the common State control has no influence over the reporting entity.

44. To attempt to capture this, the staff suggests that entities will initially be considered to be exempt from the disclosures requirements. Thus, reporting entities are making the assertion that common control from the State does not give rise to transactions that need to be disclosed by the reporting entity. However, amendments to IAS 24 would include a number of indicators that may identify that related party relationships exist and that the entity should be disclosing the relationship and transactions. The staffs initial thoughts are that indicators could include the following situations:

(a) Common board members between the two entities controlled by the State;

(b) The existence of direction or compulsion from the government for entities to act in a certain way;

(c) The existence of transactions at non market rates between the two entities (other than by way of regulation);

(d) The use of shared resources; or

(e) Economically significant transactions between the common controlled entities.

45. This is not an exhaustive list but more an indication of the types of situations that could give rise to relationships that should be disclosed under IAS 24. If an entity meets one of the indicators then the staff thinks the entity must comply with all of the requirements in IAS 24. The staff think that including a list of indicators will help to target the ‘at risk’ transactions that IAS 24 is trying to capture, and thus will ensure that relevant disclosures are made when

necessary. If the Board agree with the initial proposal, further work will be completed on the list of indicators.

46. In situations where an entity does not need to make the disclosures in IAS 24 there are two options. Either an entity can disclose nothing in regards to relationships with other entities controlled by the State, or they may disclose some information about other state-controlled entities. For example:

> '*Nothing has come to our attention* to indicate that a related party relationship exists with any other state-controlled entities.'

Recommendation

47. **Does the Board agree that to distinguish between those transactions that should and should not be disclosed, a number of indicators similar to that in paragraph 44 should be the included in IAS 24?**

48. **Further, does the Board agree that the full requirements of IAS 24 paragraph 17 should be complied with if any of the indicators exist? Does the Board agree that, if the entity does not meet any of the indicators some disclosure should be required to declare that nothing has come to their attention?**