30 Cannon Street, London EC4M 6XH, United Kingdom
Tel: +44 (0)20 7246 6410 Fax: +44 (0)20 7246 6411
E-mail: iasb@iasb.org Website: www.iasb.org

International Accounting Standards Board

INFORMATION FOR OBSERVERS

Board Meeting: **19 October 2007, London**

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

Subject: **Redeliberations: Project Objective and Scope (Agenda paper 15A)**

INTRODUCTION

1. At the Board meeting in September, the staff outlined the issues raised in comment letters on the exposure draft [ED] of proposed amendments to IAS 24 Related Party Disclosures – *State-controlled Entities and the Definition of a Related Party*. Those issues received on the ED broadly separate into issues regarding project objective and scope and issues regarding each question raised in the ED.

2. This paper considers issues related to project objective and scope and asks the Board to make a decision about these issues. Agenda Paper 15B considers issues related to Question 1 raised in the ED (State-controlled Entities).

3. This paper divides into two sections:

   (a) Section 1: Project objective and scope
   (b) Section 2: Issues raised in the comment letters

SECTION 1: PROJECT OBJECTIVE AND SCOPE

4. This project is a short term project with a limited scope and was not intended to fundamentally reconsider IAS 24. The objective and scope of the project can be outlined as follows:
   (a) providing an exemption from the disclosure requirements in paragraph 17 of IAS 24 for entities that are related simply because of control or significant influence by a common state;
   (b) amending the definition of a related party to clarify the intended meaning and to remove some inconsistencies when the definition is considered from the perspective of different reporting entities;
   (c) amending the definition of a related party transaction to clarify the intended meaning; and
   (d) other minor amendments (not discussed below).

Exemption from the disclosure requirements in paragraph 17 of IAS 24

5. The ED contained proposals to amend IAS 24 *Related Party Disclosures*. The amendments would exempt entities that are controlled or significantly influenced by a state from the disclosure requirements in paragraph 17 of IAS 24 in relation to transactions with other entities controlled or significantly influenced by that state. The exemption does not apply when the reporting entity that is controlled or significantly influenced by a state influenced, or was influenced by, the other entity that is controlled or significantly influenced by that state.

Amending the definition of a related party

6. The ED also proposed amending the definition of a related party, for four reasons. First, the Board considered the relationship between an associate and a subsidiary of an entity ('the investor'). IAS 24 requires disclosure of transactions between an associate and a subsidiary of the investor in the individual or separate financial statements of the associate, but not in the individual or separate financial statements of the subsidiary. The Board proposed to change the definition of a related party to ensure that an associate and a subsidiary of an entity are related parties of each other for their

individual, or separate, financial statements. Similarly, the Board proposed that if the investor is a person who significantly influences one entity and controls another entity, those entities are related parties of each other.

7. Secondly, the Board considered the relationship between associates of the investor. IAS 24 does not define associates as related to each other if the investor is an entity. However, if a person significantly influences one entity and a close member of that person's family significantly influences another entity, those entities are currently related parties of each other. The Board proposed to amend the definition of a related party to exclude such entities, thereby ensuring consistent treatment of all associates.

8. Thirdly, IAS 24 treats some investees* of the key management personnel of an entity preparing its financial statements (in this ED, referred to as the 'reporting entity') as related to the reporting entity. However, the definition in IAS 24 does not include the reciprocal of this—i.e. in the financial statements of the investee, the reporting entity is not a related party. The Board proposed to amend the definition so that the entities are defined as related parties in both sets of financial statements.

* *Investees include entities controlled, jointly controlled or significantly influenced by an investor or in which the investor holds significant voting power.*

9. Lastly, in response to comments that the definition of a related party is difficult to understand and interpret, the Board proposed to restructure it. The restructuring is not intended to change the meaning of a related party except for the changes described in paragraphs 6–8 above.

Amending the definition of a related party transaction

10. The current definition of a related party transaction contains the wording 'between related parties'. The Board noted that this can be interpreted as requiring an entity to disclose transactions between two of its related parties. Such an interpretation was not the Board's intended meaning – the definition was intended to include only those transactions between the reporting entity and its related parties. Therefore, the Board proposed amending the wording to 'between a reporting entity and a related party'.

11. The Board also discussed situations in which an entity entered into a contract to do something in the future, but there has not yet been a transfer of resources. The Board proposed to add a sentence to paragraph 20 to clarify that the definition of a related party transaction includes this situation.

SECTION 2: ISSUES RAISED IN THE COMMENT LETTERS

12. The following issues raised in the comment letters relate to the project objective and scope outlined in section 1:

    (a) extending the exemption (paragraphs 13-26);
    (b) fundamentally reconsidering the definition of a related party (paragraphs 27-32);
    (c) inclusion of 'best endeavours clause' in IAS 24 (paragraphs 33-35);
    (d) inclusion of some materiality guidelines (paragraphs 36-39); and
    (e) exemption for subsidiaries (paragraphs 40-42).

Extending the exemption

13. The issue 'Extending the exemption' separates into two issues. One issue is '*Extending the exemption to other types of entities*'. The other issue is '*Extending the exemption to transactions between state-controlled entities and a state, or transactions between a reporting entity (including state-controlled entities) and a person*'.

14. The ED proposed an exemption from the disclosure requirements in paragraph 17 of IAS 24 for entities that are controlled or significantly influenced by a common state unless influence exists between those entities. The specific reasons are as follows:

    (a) In jurisdictions with a large number of state-controlled entities, or entities over which the state has significant influence, it can be difficult to identify other entities that are controlled or significantly influenced by the state. Entities that are controlled or significantly influenced by the state might not even be aware that an entity with which they have transactions is a related party.
    (b) The cost of meeting the requirements in IAS 24 for entities controlled or significantly influenced by the state is not always offset by the benefit of increased information for users of financial statements. More specifically:
        (i) extensive disclosures are required for transactions that are unaffected by the relationship;

(ii) if some entities that are controlled or significantly influenced by the state are not aware that their transactions are with a fellow subsidiary or associate, the disclosures provided will be incomplete; and

(iii) transactions that are affected by a related party relationship, and information that is potentially useful to users of the financial statements, might well be obscured by excessive disclosures about unaffected transactions.

(c) Some states establish subsidiaries and associates to compete with each other. Moreover, subsidiaries and associates within a state can have different boards of directors with different objectives and goals. In these cases, transactions between such entities are likely to be conducted as if they are unrelated parties.

Extending the exemption to other types of entities

15. Many respondents ask the Board to consider extending the proposed exemption to other types of entities for the following reasons:

(a) to result in a more robust and principle-based standard with a single, universally applied principle as opposed to a principle and an exception to that principle;

(b) to reduce clutter in the notes to financial statements;

(c) to align the principle underlying paragraph 17 with the stated objective in paragraph 1 of IAS 24;

(d) to avoid granting a competitive advantage to state-controlled or influenced entities in comparison to other entities; and

(e) because all of the considerations included in BC11 and BC12 of the ED are equally valid to other types of entities.

16. During deliberations for the ED, the Board concluded that influence could be much more likely to exist between entities controlled by an entity that is *not* a state than between state-controlled entities, by considering the situations in the following paragraphs 17-18.

17. IAS 24 assumes that entities related through common control might not act independently of each other. In the case of entities *not* controlled by the State, 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 to have transactions they might not otherwise have entered into, complete transactions at non-market rates, or do things that are they might not consider to be in their own best interests.

18. However, for state-controlled entities, the likelihood of influence through State ownership has decreased because jurisdictions have moved from a policy of 100% owned State entities to only partial State ownership over time. 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 into transactions might not exist. Furthermore, common State control might not affect or influence transfer pricing between entities within a group.

19. The staff notes that the exemption proposed in the ED applies only when influence does not exist between state-controlled entities.

20. Considering the conditions as described in paragraphs 16-19, the staff thinks that although the exemption could be extended to entities controlled by an entity that is *not* a state, the exemption would not apply in most cases as opposed to state-controlled entities. Furthermore, transactions between those entities would be useful enough to require disclosures to users of the financial statements. Therefore, the staff recommends that the Board should not extend the exemption to other types of entities. **Does the Board agree with the staff's recommendation?**

Extending the exemption to transactions between state-controlled entities and a state, or transactions between a reporting entity (including state-controlled entities) and a person

21. A few respondents ask the Board to consider extending the proposed exemption to transactions between state-controlled entities and a state or state organisations.

22. A few respondents suggest extending the proposed exemption to transactions between a reporting entity (including state-controlled entities) and a person who is a related party, such as key management personnel, for the following reasons:
    (a) The word 'entity' in paragraph 17A suggests that the exemption will not apply when an individual that is a related party, such as key management personnel, transacts with a state-controlled entity at arms' length.
    (b) In some instances, key management personnel do not know that the counterparty is a member of the group (including a state-controlled entity). Therefore, the related party information required of key management personnel and their close family members can be incomplete, not useful and irrelevant.
    (c) Transactions between the reporting entity and key management personnel or their close family members are domestic in nature and unrelated to the person's position with the entity.

23. During deliberations for the ED, the Board concluded that influence could be much more likely to exist between state-controlled entities and a state itself or between a reporting entity (including state-controlled entities) and a person such as key management personnel, rather than between state-controlled entities, by considering the situation outlined in the following paragraph 24.

24. 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. 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. The potential that the relationship could affect the transactions on balance creates the need to disclose related party transactions.

25. The staff notes that the exemption proposed in the ED applies only when influence does not exist between state-controlled entities.

26. Considering the conditions as described in paragraphs 23-25, the staff thinks that although the exemption could be extended to other related party relationships, the exemption would not apply in most cases as opposed to state-controlled entities. Furthermore, transactions in other related party relationships would be useful enough to require disclosures to users of the financial statements. Therefore, the staff recommends that the Board should not extend the exemption to other related party relationships. **Does the Board agree with the staff's recommendation?**

Fundamentally reconsidering the definition of a related party

27. The ED proposed amending the definition of a related party to clarify the intended meaning and to remove some inconsistencies.

28. Several respondents observe the following about both the current and the proposed definition of a related party:
    (a) significant influence is enough to influence transactions between the reporting entity and the related party; and
    (b) the revised definition seems rules based rather than principles based. As a result, it is not possible to tell from what principle the current exhaustive listing of related parties is derived.

29. Some respondents suggest providing a principle for the definition of a related party. Furthermore, they think that with a principle, either indicators or examples of the principle could be provided in the Application Guidance. One respondent proposes that the Board reconsider both the current and proposed definition fundamentally and in doing so, should limit the definition to those relationships distinguished by control. This approach would significantly alleviate the burden on preparers and increase the decision-usefulness of the reported disclosures because many irrelevant disclosures would be eliminated.

30. The staff notes that the same issue was raised on the ED for IAS 24 revised in 2003- i.e. Improvements project and the Board regarded that issue as outside the scope of the Improvements project.

31. The staff also notes that an underlying principle for the definition of a related party may need further long term research and be convergence issue.

32. Therefore, the staff recommends that the Board should not reconsider the definition of a related party in this amendments project. **Does the Board agree with the staff's recommendation?**

Inclusion of a 'best endeavours clause' in IAS 24

33. Two respondents suggest including 'best endeavours clause' because it would better align the standard with reality. The 'best endeavours clause' is that if an entity has been unable to obtain the necessary information on relationships in spite of using its best endeavours, that disclosure is not required.

34. The staff does not recommend that the Board should include 'best endeavours clause' in IAS 24 because it is outside the project objective and scope and it is not appropriate to include the clause for the following reasons:
    (a) The term 'best endeavours' is very subjective and could result in divergence in practice and as a result, lack of comparability.
    (b) This term could also result in very minimal disclosure being made in situations where actual related party relationships may exist.
    (c) This issue is not confined to this standard and may be related to other standards, particularly including disclosure requirements.

35. **Does the Board agree with the staff's recommendation in paragraph 34?**

Inclusion of some materiality guidelines

36. Two respondents suggest that the standard should explicitly state that disclosure is required of material related party transactions and give more guidance on materiality for such transactions, with particular reference to materiality from the perspective of either related party and the qualitative considerations that are arguably more important than quantitative factors in these cases.

37. The staff notes that the same issue was raised on the ED for IAS 24 revised in 2003- i.e. Improvements project and the Board regarded that issue as outside the scope of the Improvements project.

38. The staff also notes that the IFRIC considered this issue in respect of IAS 24 (revised 1994) in April 2003, and decided not to take this issue onto its agenda on the grounds that the *Framework* and IAS 1 *Presentation of Financial Statements* give sufficient guidance on the meaning of material. Furthermore, materiality depends on the entity concerned and the existing circumstances. Thus, to provide specific guidance could impede the objective of appropriate disclosure.

39. The staff thinks that this issue is outside the project objective and scope for the reasons provided in paragraphs 37-38. Therefore, the staff recommends that the Board should not provide materiality guidance in IAS 24. **Does the Board agree with the staff's recommendation?**

Exemption for subsidiaries

40. A few respondents suggest that an exemption be provided for the financial statements of subsidiaries whose parents prepare consolidated financial statements that are available for public use. For example, the subsidiaries that the group controls 90 per cent or more of their voting rights, or wholly owns. The arguments given by them are as follows:

    (a) The information disclosed in the subsidiaries' stand-alone statements would just repeat the information included in the consolidated accounts.

    (b) There is a clear need for a cost/benefit analysis to be undertaken as the lack of an exemption imposes onerous burdens on groups.

41. The staff notes that in the exposure draft for IAS 24 (revised 2003), as provided in IAS 24 (revised 1994), the Board proposed not to require disclosure of related party transactions and outstanding balances in the separate financial statements of a parent or wholly-owned subsidiary that are published with consolidated financial statements for the group to which that entity belongs. However, in the light of constituents' response, the current

IAS 24 (revised 2003) requires disclosure of transactions in the separate financial statements.

42. The staff recommends that the Board should not provide any exemption for subsidiaries whose parents prepare consolidated financial statements that are available for public use, because this is outside the project objective and scope, and was already considered and there are now no new reasons to change the previous Board's conclusion. **Does the Board agree with the staff's recommendation?**